

# CONVERGENCE IN MODELS OF REGULATORY STRATEGY

*John Braithwaite*<sup>1</sup>  
Department of Law  
Research School of Social Sciences  
Australian National University

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## INTRODUCTION

There is an emerging convergence between rational actor and normative accounts of what works in securing compliance with regulatory laws. This convergence is about the efficacy of tit-for-tat enforcement - regulation that is contingently tough and forgiving. Building on this convergence, the possibility is considered that regulatory agencies will be best able to secure compliance when they are Benign Big Guns. That is, regulators will be more able to speak softly when they carry big sticks (and crucially, a hierarchy of lesser sanctions). Paradoxically, the bigger and the more various are the sticks, the more regulators will achieve success by speaking softly.

## CONVERGENCE IN MODELS OF REGULATORY STRATEGY

A deal of contemporary social science is a stalemate between theories assuming economic rationality on the part of actors and theories counterposing action as variously motivated by the desire to comply with norms, to maintain a sense of identity, or to do good. The contention of this paper is that theory is most likely to be robust where there is convergence between the implications of rational actor and moral actor accounts. So in the culture of our social science, we might well search for arenas of convergence between materialist and idealist analysis instead of continuing to seek battlegrounds for new clashes between these traditions.

Much barren scholarly disputation has raged between a majority view that corporations will only comply with the law when faced with rational incentives and a minority view that corporate actors internalise the values in the law in a way that leaves them open to persuasion and self-regulation. Empirically, among regulators themselves, the latter has been found to be the majority account.<sup>2</sup>

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- 1 Paper delivered at a Public Seminar entitled "Occupational Health and Safety and Environmental Protection: Current Policies and Practices in the Social Control of Corporate Crime", convened by the Institute of Criminology, 25 October 1989
  - 2 See the studies cited by Hawkins, K., *Environment and Enforcement: Regulation and the Social Definition of Pollution* (1984) p 3

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Attempts have recently been made to model the intuition that regulatory agencies do best at securing compliance with their statutes by striking some sort of sophisticated balance between punishment and persuasion. At the same time that I was struggling with such an attempt in Australia,<sup>3</sup> Scholz was doing so in a very different way in the United States.<sup>4</sup> Although Scholz and Braithwaite posit contrary premises about human motivation and different intervening processes, their theories converge at a key point, namely the efficacy of regulation that is contingently tough and forgiving.

Scholz models regulation as a prisoner's dilemma game wherein the motivation of the firm is to minimize regulatory costs and the motivation of the regulator is to maximize compliance outcomes.<sup>5</sup> A tit-for-tat enforcement strategy is shown to be that most likely to establish mutually beneficial cooperation. Tit-for-tat (TFT) means that the regulator refrains from a deterrent response so long as the firm is cooperating. But when the firm yields to the temptation to exploit the cooperative posture of the regulator and cheats on compliance, then the regulator shifts from a cooperative to a deterrent response. Confronted with the matrix of payoffs typical in the enforcement dilemma, the optimal strategy is for both the firm and the regulator to cooperate until the other defects from cooperation. Then the rational player should retaliate (to deterrence regulation on the part of the state; to a law evasion strategy by the firm). If the retaliation secures a return to cooperation by the other player, then one should be forgiving, restoring the benefits of mutual cooperation in place of the lower payoffs of mutual defection. Drawing on the work of Axelrod,<sup>6</sup> Scholz contends that in prisoner's dilemma games TFT has been demonstrated mathematically, experimentally and through the use of computer simulation tournaments against other sophisticated strategies to maximize the payoffs of players in many circumstances.

Scholz's theory of the evolution of cooperation is a positive theory of why cooperation should evolve by virtue of the rationality of players seeking optimum payoffs. Second, it is a positive theory of what is the best strategy for securing compliance with the law. Third, it can be the basis of a normative theory of how regulators ought to act. In this comment, discussion will be limited to the potential for the second kind of theoretical contribution. Scholz has a limited theory of the first type - of the political realities of how regulators and corporations in fact act - particularly because of its implied assumption of equality of power between regulatory players. But my own work is even more fallible in this regard since it includes no theory at all of how regulatory strategies evolve. While my work is

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3 Braithwaite, J., "Enforced Self-Regulation: A New Strategy for Corporate Crime Control" (1982) 80 *Michigan Law Review* pp 1466-1507; and Braithwaite, J., *To Punish or Persuade: Enforcement of Coal Mine Safety* (1985)

4 Scholz, J.T., "Deterrence, Cooperation and the Ecology of Regulatory Enforcement" (1984) 80 *Law and Society Review* pp 179-224 and Scholz, J.T., "Voluntary Compliance and Regulatory Enforcement" (1984) 6 *Law and Policy* pp 385-404

5 *ibid.*

6 Axelrod, R., *The Evolution of Cooperation* (1984)

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embedded in a normative account of how business regulation ought to be done, here we will consider it simply as a positive theory of what regulatory strategy will be most effective in securing compliance with a pre-given law.

Thus reconstructed, Braithwaite's theory<sup>7</sup> is based on six postulates:

- Some corporate actors will only comply with the law if it is economically rational for them to do so. Most corporate actors will comply with the law most of the time simply because it is the law. All corporate actors are bundles of contradictory commitments to values about economic rationality, law abidingness and business responsibility. Business executives have profit-maximising selves and law-abiding selves; at different moments, in different contexts, the different selves prevail.
- A strategy based totally on persuasion and self-regulation will be exploited when actors are motivated by economic rationality.
- A strategy based mostly on punishment will undermine the good will of actors when they are motivated by a sense of responsibility.
- Punishment is expensive; persuasion is cheap. A strategy based mostly on punishment wastes resources on litigation that would be better spent on monitoring and persuasion. (A highly punitive mining inspectorate will spend more time in court than in mines.)
- A strategy based mostly on punishment fosters an organized business subculture of resistance to regulation wherein methods of legal resistance and counterattack are incorporated into industry socialisation.<sup>8</sup> Punitive enforcement engenders a game of regulatory cat-and-mouse whereby firms defy the spirit of the law by exploiting loopholes, and the state writes more and more specific rules to cover the loopholes. The result can be:
  - rulemaking by accretion that gives no coherence to the rules as a package, and
  - a barren legalism concentrating on specific, simple, visible violations to the neglect of underlying systemic problems.
- Heavy reliance must be placed on persuasion rather than on punishment in industries where technological and environmental realities change so quickly that the regulations which give detailed content to the law cannot keep up to date.

If these premises are correct, a strategy for mixing punishment and persuasion is needed. At one level, TFT is the mix that resolves these contradictions. By cooperating with firms until they cheat, the counterproductivity of undermining the good faith of socially responsible actors is averted. By nurturing expectations of responsibility and cooperation within the regulatory culture,<sup>9</sup> the regulator can coax and caress fidelity to the spirit of the law even in contexts where the law is riddled with gaps or loopholes. By getting tough with cheaters, actors are made to suffer

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7 Braithwaite (1985) *op.cit. supra* n. 3

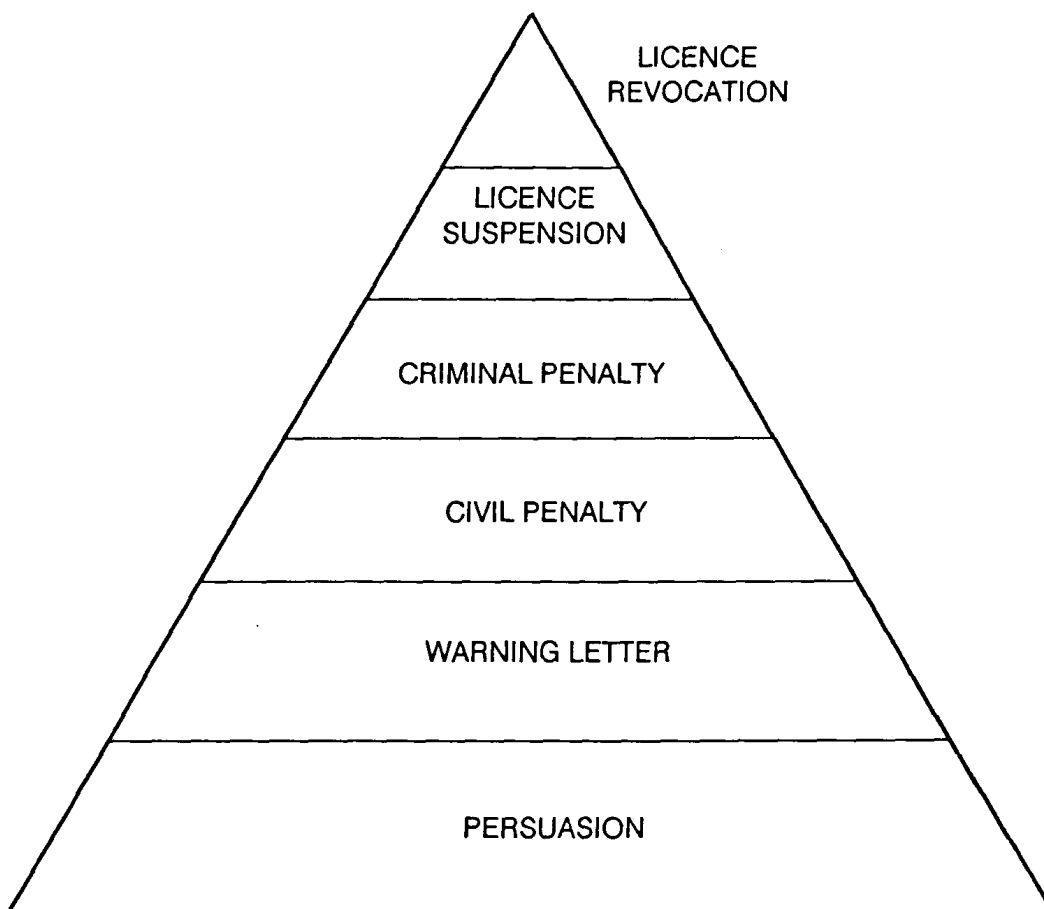
8 Bardach, E. and Kagan, R., *Going by the Book: The Problem of Regulating Unreasonableness* (1982)

9 Meidinger, E., "Regulatory Culture: A Theoretical Outline", (1986) 9 *Law and Policy* pp 355-86

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when motivated by their rational economic selves, and are given reason to favour their socially responsible, law-abiding selves. In short, they are given reason to reform, more so because when they do reform they find the regulator forgiving.

*To Punish or Persuade* argued, however, for a more elaborate strategy for mixing punishment and persuasion than just TFT. The contention was that compliance was most likely when the regulatory agency displayed an explicit enforcement pyramid. An example of an enforcement pyramid appears in Figure 1.



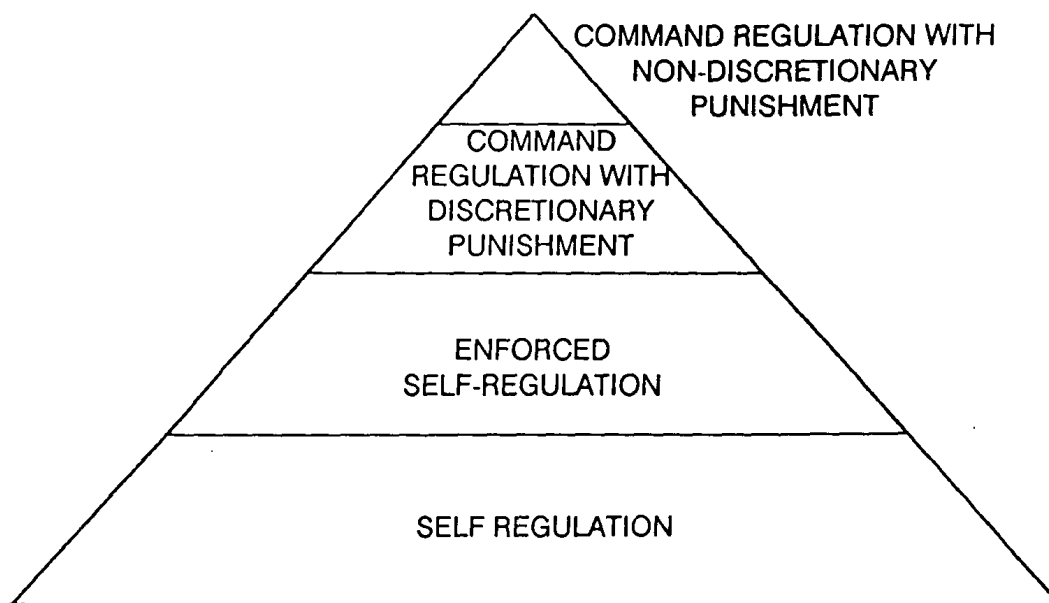
**Figure 1** Example of an enforcement pyramid. The proportion of space at each layer represents the proportion of enforcement activity at that level.

Most regulatory action occurs at the base of the pyramid where initially attempts are made to coax compliance by persuasion. The next phase of enforcement escalation is a warning letter; if this fails to secure compliance, civil monetary penalties are imposed; if this fails, criminal prosecution ensues; if this fails, the plant is shut down or a license to operate is suspended; and if this fails, the license to do business is revoked. This particular enforcement pyramid would be appropriate to some

regulatory arenas but not others. The form of the enforcement pyramid is the subject of the theory, not the content of this particular pyramid.

The idea of the enforcement pyramid has advantages over the bipolar TFT notion of switching between cooperation and deterrence. Defection from cooperation is a less attractive option for a firm when confronted with a regulator armed with an enforcement pyramid than when confronted with a regulator having only one deterrence option. This is true even where the deterrence option is maximally potent. Actually, it is especially true where the single deterrence option is cataclysmic. It is not uncommon for regulatory agencies to have the power to withdraw or suspend licenses as the only effective power at their disposal. The problem is that the sanction is such a drastic one (for example, putting a TV station off the air), that it is politically impossible and morally unacceptable to use it with any but the most extraordinary offenses. Hence, such agencies often find themselves in the situation where their implied plea to "cooperate or else" has little credibility. Regulators have maximum capacity to lever cooperation when they can escalate deterrence in a way that is responsive to the degree of uncooperativeness of the firm, and the moral and political acceptability of the response.

It follows from the postulate of the theory about an organized business subculture of resistance, that we should transcend the view of regulation as a game played with single firms. In some respects industry associations can be more important players. For example, individual firms will often follow the advice of an industry association to cooperate on a particular regulatory requirement because if the industry does not make this requirement work, it will confront a political backlash which may lead to more intervention. Hence, the importance of a pyramid of regulatory strategies pitched at the entire industry (see Figure 2), as well as a pyramid of sanctions directed at individual firms (see Figure 1).



**Figure 2** Example of a pyramid of enforcement strategy

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*To Punish or Persuade* argued that the state is most likely to achieve regulatory goals at least cost to taxpayers and industry by communicating to industry that in any regulatory arena the preferred strategy is industry self-regulation. However, given that industry will often exploit the privilege of self-regulation, the state must also communicate its willingness to escalate regulatory strategy up the further pyramid of interventionism exemplified in Figure 2. Again the content of the pyramid (defended in *To Punish or Persuade*) is not the issue. One could conceive of another regulatory pyramid that might escalate from self-regulation to negative licensing,<sup>10</sup> to positive licensing, to taxes on harm.<sup>11</sup>

Any appropriate pyramid of interventionism enables the state to communicate its preparedness to escalate up the pyramid, thereby giving both the industry and regulatory agents incentives to make regulation work at lower levels of intervention. The key contention is that the gradients and peaks of the two enforcement pyramids create downward pressure which causes most of the action to occur at the base of the pyramid - in the realms of persuasion and self-regulation. The irony is that the existence and signalling of the capacity to get as tough as is needed can usher in a regulatory culture more voluntaristic and less litigious than is possible when the state rules out adversariness and punitiveness as an option. Lop the tops off the enforcement pyramids and there is less prospect of self-regulation and less prospect of persuasion as an alternative to punishment.

I now want to suggest that we can build further on the convergent theoretical foundations of Scholtz's work and my own. This elaboration was stimulated by the emergence of a "Benign Big Gun" cluster of agencies from the application of a variety of multivariate techniques to taxonomize 96 Australian regulatory agencies according to patterns of enforcement behavior.<sup>12</sup> The Benign Big Guns were agencies that walked softly while carrying very big sticks. The agencies in the cluster were distinguished by having enormous powers: the power of the Reserve Bank to take over banks, seize gold, increase reserve deposit ratios; the power of the Australian Broadcasting Tribunal to completely shut down business by revoking licenses; or the power of oil and gas regulators to stop production on rigs at stupendous cost. The core agencies in this cluster had such enormous powers but never, or hardly ever, used them. They also never or hardly ever used the lesser power of criminal prosecution. The Broadcasting Tribunal's strategy was once characterized by counsel for the Australian Consumers' Association as "regulation by raised eyebrows" and the Reserve Bank strategy has been described as "regulation by vice-regal suasion".

The data from this study are not adequate for measuring the relative effectiveness of these 96 agencies in achieving their regulatory goals. Nevertheless, the empirical association between speaking softly and carrying big sticks is an

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10 See Grabosky, P. and Braithwaite, J., *Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies* (1986)

11 Anderson, F.R., et al., *Environmental Improvement Through Economic Incentives* (1977)

12 Grabosky and Braithwaite, *op.cit. supra* n. 10; and Braithwaite, J., et al., "An Enforcement Taxonomy of Regulatory Agencies" (1987) 9 *Law and Policy* pp 325-350

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interesting basis for theoretical speculation. Might it be that the greater the heights of punitiveness to which an agency can escalate, the greater its capacity to push regulation down to the base of the enforcement pyramid? A flat pyramid (with a truncated range of escalations) will exert less downward pressure to keep regulation at its base than a tall pyramid. A tall enforcement pyramid can be used to apply enormous pressure from the heights of its peak to motivate 'voluntary' compliance. Thus, the key propositions of a Benign Big Gun theory of regulation would be that successful pursuit of cooperative regulation and maximum compliance with the law is predicted by:

- use of a tit-for-tat strategy;
- access to a hierarchical range of sanctions and a hierarchy of interventionism in regulatory style (the enforcement pyramids); and
- how extreme in punitiveness is the upper limit of the range of sanctions.

In presenting this conceptual note, I wish to be clear and provocative about these three interconnected ideas. But I also mean to be tentative. The first need is for fieldwork, in the tradition exemplified by Hawkins,<sup>13</sup> to ground if and how regulators come to be granted the credibility of being Benign Big Guns. Hawkins' work raises questions about how direct is the link between the image of invincibility regulators can sustain and the calibre of their firepower. What are the limits, if any, on the capacity of regulators to bluff their way to an image of invincibility?

The important point concerns the possibilities for convergence between theories derived from rational and normative accounts of human motivation. Analyses of what makes compliance rational and what builds business cultures of social responsibility can converge on the conclusion that compliance is optimized by regulation that is contingently tough and forgiving. For Scholz, forgiveness for firms planning to cooperate in future is part of maximizing the difference between the cooperation and confrontation payoffs. In *To Punish or Persuade*, forgiveness is advocated more for its importance in building commitment to comply in future. In Scholz's formulation, punishment is all about deterrence. I place greater importance on the moral educative effects of punishment, and on the role of punishment in constituting an image of invincibility within a regulatory culture.

Both accounts, from their different premises, move away from the notion of an optimum level of stringency in the law, an optimum level of enforcement, and an optimum static strategy, and instead converge toward an optimum way of playing a dynamic enforcement game. Of course it remains to be seen whether the product of this convergence is empirically robust, and whether we can build upon it a Benign Big Gun theory of regulatory power.

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13 Hawkins, *op.cit. supra* n. 2

