

Rewards and Regulation

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Rewards are less useful in regulation than they are in markets. Firms respond to market incentives because most markets are contestable. In markets that are not oligopolies it makes more sense to adopt a competitor mentality than a fixer mentality. Regulatory power in contrast is mostly not contestable. Firms are therefore more likely to adopt a fixer or game-playing mentality. Reactance to regulatory control through rewards is likely to be greater than reactance to market discipline. If a responsive regulatory pyramid is a good strategy for optimizing compliance, then punishment is more useful in regulation than reward. Reward at the middle of a regulatory pyramid brings about a moral hazard problem. Under certain limited conditions reward can be useful at the base of a regulatory pyramid. These conditions are transparent, easy measurement of the performance to be rewarded, an imbalance of power such that the regulatee is weak in comparison to the regulator, and an absence of weapons of the weak for subverting a regulatory system to which the weak are subject. Absent these conditions, and we cannot expect the undoubted efficiency advantages of a market where regulatory outcomes can be traded so that they are secured where the cost of doing so is least. While, in general, punishments are more useful to regulators than monetary rewards, informal rewards (praise, letters of recognition) are rather consistently useful in securing compliance.

Psychologists and economists do not agree on much about how to motivate human behaviour. One major point of convergence, however, is on the view that rewards are more useful than punishments in motivating human behaviour. For the economists, rewards for achieving, say, an environmental outcome have the further advantage that the efficiency of a market for environmental improvement might be accomplished – trading in a market for environmental rewards will secure the greatest reductions in environmental impact where it is cheapest to produce them. But these important efficiency

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advantages will be moot in contexts where rewards fail to motivate behavioural change.

In popular diagnoses of how to get things done as well, the view that carrots are better than sticks is also widespread. This view is regularly articulated with respect to business regulation. In the reaction against the adversarial legalism¹ of command-and-control regulation, the two dominant prescriptions have been a shift from coercive to cooperative regulation, from punishment to persuasion,² and from punishment to reward³ or from command and control to market-based incentives.⁴

Those of us who have been regulatory professionals for a long time have served on endless committees charged with curbing the excesses of command-and-control regulation where one of the issues we were asked to consider was whether carrots could be substituted for some of the sticks used in extant arrangements. And we will have had the experience of coming up empty handed – the committee fails to recommend any reforms it regards as practical ways of substituting rewards for punishments. The reason for this is that in the context of business regulation punishments are in fact more useful tools than rewards. In raising children it is generally better to wait until they manifest a desired behaviour like reading books, then reward it, than it is to punish failure to do so. This is the basis for the psychologist's preference for rewards. In markets, incentive in the form of extra money is what makes the world go round. This is the basis for the economist's preference for rewards. They are both wrong, I will argue, when they translate this preference into the domain of business regulation. Here punishments are more valuable than rewards for securing compliance. This conclusion is not startlingly original; Jeremy Bentham believed that while rewards were powerful in markets and while they had some uses in law, rewards were a less valuable tool for the legislator than punishments.⁵ On the former he was in agreement with Adam Smith, but he did not share Smith's enthusiasm for rewards in regulation.⁶ 'Punishment is an instrument for the extirpation of noxious weeds: reward is a hot bed for raising fruit, which would not otherwise be produced.'⁷ In this essay, I will advance in

1 E. Bardach and R.A. Kagan, *Going By The Book: The Problem of Regulatory Unreasonableness* (1982).

2 F. Haines, *Corporate Regulation: Beyond 'Punish or Persuade'* (1997).

3 P. Grabosky, 'Regulation by Reward: On the Use of Incentives as Regulatory Instruments' (1996) 17 *Law and Policy* 256–81.

4 N.O. Keohane, R.L. Revesz, and R.N. Stavins, 'The Choice of Regulatory Instruments in Environmental Policy' (1998) 22 *Harvard Environmental Law Rev.* 313–67.

5 J. Bentham, *The Rationale of Reward*, eds. J. and H.L. Hunt (1825) 6, 51–2; J. Bentham, *Collected Works of Jeremy Bentham: Principles of Legislation: A Comment on the Commentaries and a Fragment on Government*, eds. J.H. Burns and H.L.A. Hart (1977) 75–7, 79.

6 *id.* (1825), p. 52.

7 *id.*, p. 51.

turn a contestability argument, a reactance argument, and a responsiveness argument for why rewards do not enjoy the superiority over punishment in regulation that they enjoy in markets.

CONTESTABILITY

The rewards provided by markets, as we have said, generally work in motivating productive efficiency. But not always. Most firms respond to the challenge of a market for the product they sell by competing with a customer-service mentality. An alternative path is to seek to fix the market, to rig bids with competitors, to form cartels that fix prices or allocate markets geographically. Most business opts for the competitive mentality rather than the fixer mentality because cartels are hard to hold together. Fixers also find ways to cheat on the other members of the cartel to attract business to themselves, for example, by under-the-table rebates to customers. Markets are always contestable by new entrants which are not members of the cartel when monopoly prices are being charged. This is especially so in contemporary conditions of global markets where foreign competition can enter the market to contest for the business of local cartels.

With business regulation, however, it is not always the case that the competitor mentality dominates the fixer mentality. When a regulator puts in place a system of rewards for achieving an outcome like pollution reduction, firms that already have leading pollution control capabilities will compete aggressively for those rewards. The majority of firms that have poorer capabilities, however, tend to do what they can to put in the fix to prevent the compliance leaders from getting this competitive jump on them.⁸ Their pursuit of the fixer mentality takes many forms. They lobby through industry associations to subvert or delay the reforms industry-wide, they make special pleadings for exemptions for themselves, they fudge their compliance data, bribe inspectors who then assert that the compliance data is not as claimed, or complain to their political masters about regulatory unreasonableness, but most commonly of all they indulge in what Doreen McBarnet and Christopher Whelan have called 'creative compliance'.⁹ Business regulatory outcomes tend to be complex, not black and white. Hence the dominant fixer mentality is to play for the gray.

Even in comparatively simple domains of regulation the possibility of putting in the fix to subvert the regulatory incentives is there. The Kennedy School of Government at Harvard and the Ford Foundation gave the state of Illinois an innovations in government award in the 1980s for its shift from command-and-control nursing-home regulation to a system of

8 Keohane, Revesz, and Stavins, *op. cit.*, n. 4, pp. 351–3.

9 D. McBarnet and C. Whelan, *Creative Accounting and the Cross-Eyed Javelin Thrower* (1999).

rewards (higher Medicaid payments) graduated according to the quality of care delivered (the Illinois Quality Incentives Program). Some other states, including Michigan and Massachusetts, also experimented with this approach. Valerie Braithwaite, Diane Gibson, Toni Makkal and I undertook an ethnographic study of United States nursing-home regulation during this period in all the largest states; this included observing many nursing-home inspections in Illinois.¹⁰ When rewards were put in place for the number of residents participating in activity programmes, we noted sleeping residents in wheelchairs being wheeled in to the room where an activity such as craft or a game was going on so that they could be recorded on the head count as participating. One very important standard at that time related to the existence of a 'homelike' environment. One aspect of this is the capacity of residents to domesticate their little piece of institutional space by putting up pictures of their choosing on the wall. This kind of empowerment could take many forms – rearranging the bed and other furniture, carpets, even bringing a beloved pet in to deinstitutionalize the space. But counting the pictures on the wall was the easiest quantitative way of operationalizing this standard. And, of course, quantitative measures that can be calibrated unambiguously are what inspectorates like when quantitative incentives which could be contested in a court of law hang on their ratings. Sure enough, nursing home staff told us that the large numbers of pictures of movie stars we would notice, often torn from the same magazine, had been slapped up around the nursing home on the instructions of management in anticipation of the arrival of the inspectors. Of course, they were not supposed to know when the inspectors would be arriving; but we found that fixers had a way of knowing these things. Our fieldwork even revealed cases of large numbers of pot-plants on short-term hire that were returned as soon as the inspection was completed. The bigger the incentive, the more complex the phenomenon regulated, the worse creative compliance gets.

One might say that in markets there are fixers who dupe consumers by fudging compliance with product quality or safety standards. The difference is when duped consumers discover they have been duped, they punish the supplier in the market. Inspectors generally do not do this when firms are clever enough to creatively comply with the standards they have written. Regulators figure that if they punish firms in these circumstances the agency will come under political attack for failing to write the rules of reward in a competent fashion and that courts will overturn their decisions to withhold the reward. Instead they admire the ingenuity of the firm; the inspector does not suffer personally for it, the intended beneficiaries of the regulation do. Beneficiaries such as nursing-home residents are not empowered to use

10 J. Braithwaite, 'The Nursing Home Industry' in *Beyond the Law: Crime in Complex Organizations*, eds. M. Jorjy and A. Reiss (1993).

rewards that are issued by the state to assert their claims to quality and safety.

But the more fundamental fact of this situation is that while a consumer in a market who is duped simply goes to another supplier, an inspector who is duped cannot simply walk away from the transaction. The nursing home will get some level of Medicaid payment; it would be irresponsible to cut off payments that are made to care for the residents unless the situation is life-threatening. The factory inspected by an occupational health and safety official likewise cannot be simply shut down so the inspector can use his time more productively at a factory that is more sincere about compliance. Fraud and creative compliance in market relationships are effectively contested by other suppliers. In the regulatory relationship they are not. This is reciprocally true. In general, the firm faces only one regulator with responsibility for a particular issue. The threat the regulator poses to the profits of the regulated firm is not a threat that is contested by other regulators. This is quite different from the situation with a cartel. The threat to cartel profits is posed by a number of potential entrants to the market. It is harder to put in the fix with all of them than it is with one regulator. There is just one regulator to corrupt, capture or outwit. Hence the competitor mentality dominates the fixer mentality in markets because there is more than one player to fix. The fixer dominates the competitor mentality with regulatory rewards because this contestability is absent: fix one player and you have fixed the whole game.¹¹ The absence of contestability is therefore a fundamental structural reason why reward has less power in regulation than in markets.

REACTANCE

Experimental research on children and college students demonstrates the counterproductive effect salient rewards and punishments can have: long-term internalization of values like altruism and resistance to temptation are inhibited when people view their action as caused by a reward or punishment.¹²

- 11 We can attenuate this to a degree by making the regulatory game a tripartite one in which the power to pay rewards is contested by the monitoring of non-government organizations (NGOs), see I. Ayres and J. Braithwaite, *Responsive Regulation., Transcending the Deregulation Debate* (1992). But here the NGO is only a proxy regulator of sorts; there is still just one state agency that can pay the rewards. NGOs cannot pay them.
- 12 M.R. Lepper, 'Dissonance, Self-Perception and Honesty in Children' (1973) 25 *J. of Personality and Social Psychology* 65–74; M.R. Lepper and D. Greene, *The Hidden Costs of Reward* (1978); T. Dix and J.E. Grusec, 'Parental Influence Techniques: An Attributional Analysis' (1983) 54 *Child Development* 645–52; M.L. Hoffman, 'Moral Development' in *Carmichael's Annual of Child Psychology*, ed. P.H. Mussen (1970).

Over fifty studies examining the effect of extrinsic incentives on later intrinsic motivation indicate that inducements that are often perceived as controlling (for example, tangible rewards, surveillance, deadlines), depending on the manner in which they are administered, reduce feelings of self-determination and undermine subsequent motivation in a wide variety of achievement-related activities after the reward is removed.¹³

These findings seem to be of fairly general import, being supported in domains including moral behaviour, altruism, personal interaction, aggressive behaviour, and resistance to temptation.¹⁴ Just as strong external incentives retard internalization, using reasoning in preference to power-assertion tends to promote it.¹⁵

Brehm and Brehm¹⁶ constructed a theory of psychological reactance on the basis of the kinds of studies we have been discussing. Figure 1 shows that the net effect of threats of control is the sum of a control effect and a reactance effect. According to this theory, intentions to control are reacted to as attempts to limit our freedom, which lead us to reassert that freedom by acting contrary to the direction of control. Reactance applies to attempts to control through rewards just as it applies to threats to control through punishment, though reactance effects are not as great with rewards as they are with punishments.¹⁷ Figure 1 also shows that reactance is least when we seek to restrict freedom to do something that is not very important to us, greatest when the freedom subjected to control is something the regulated actor deeply cares about. Tom Tyler might suggest that naked attempts to control us give us some negative information about our identity – that we have a subordinated identity, that we are a slave to the will of another – and this is an identity we do not

13 A.K. Boggiano, M. Barrett, A.N. Weiher, G.H. McLelland and C.M. Lusk, 'Use of the Maximal Operant Principle to Motivate Children's Intrinsic Interest' (1987) 53 *J. of Personality and Social Psychology* 866–79.

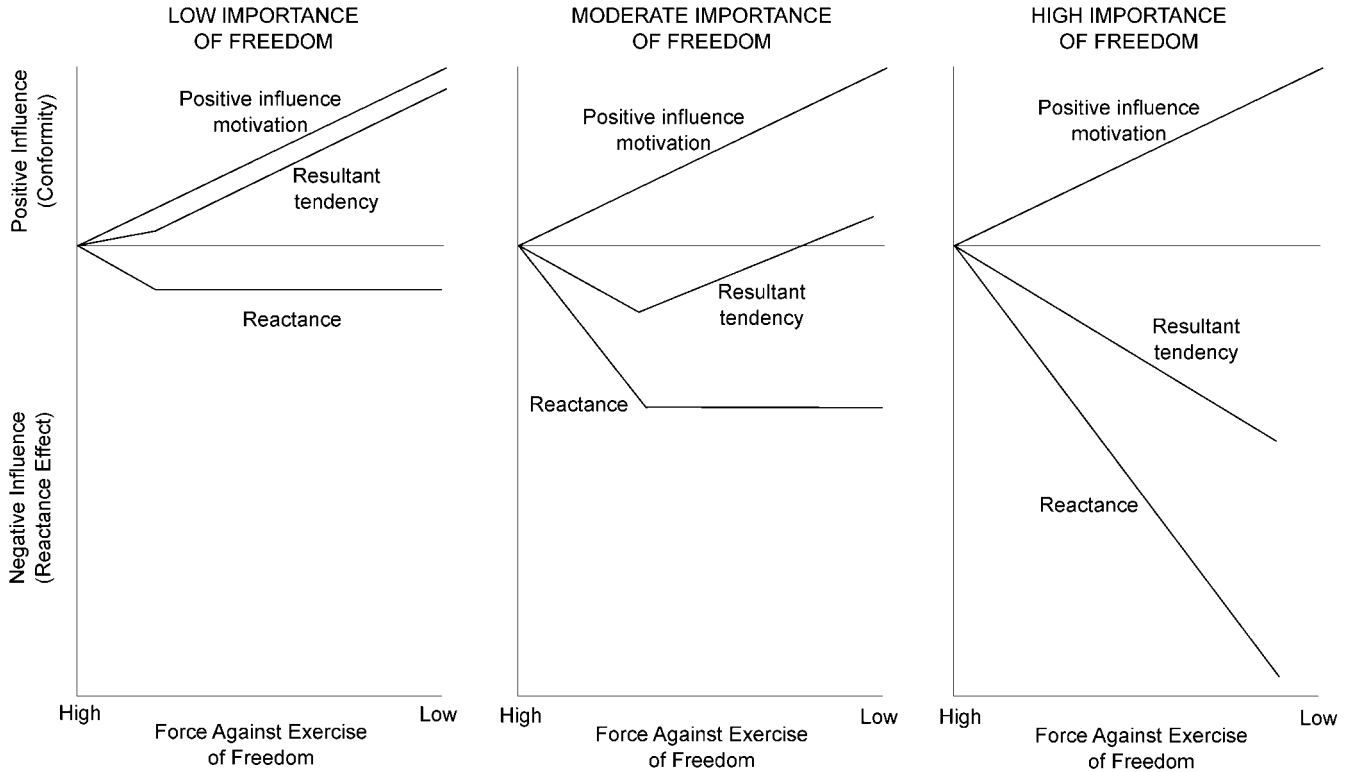
14 Boggiano et al., id.; Lepper, op. cit., n. 12; R.A. Dienstbier, D. Hillman, J. Lenhoff, and M.C. Valkenaar, 'An Emotion-Attribution Approach to Moral Behavior: Interfacing Cognitive and Avoidance Theories of Moral Development' (1975) 82 *Psychological Rev.* 229–315; Dix and Grusec, op. cit., n. 12.

15 L.A. Cheyne and R.H. Walters, 'Intensity of Punishment, Timing of Punishment, and Cognitive Structure as Determinants of Response Inhibition' (1969) 7 *J. of Experimental Child Psychology* 231–44; R.D. Parke, 'Effectiveness of Punishment as an Interaction of Intensity, Timing, Agent Nurture and Cognitive Structuring' (1969) 40 *Child Development* 213–35; Hoffman, op. cit., n. 12; D. Baumrind, 'The Development of Instrumental Competence through Socialization' in *Minnesota Symposium of Motivation*, vol. 7, ed. A.D. Pick (1973); C.Z. Zahn-Waxler, M.R. Radke-Yarrow, and R.A. King, 'Child Rearing and Children's Prosocial Initiations Towards Victims in Distress' (1979) 50 *Child Development* 319–30.

16 S.S. Brehm and L.W. Brehm, *Psychological Reactance: A Theory of Freedom and Control* (1981).

17 id., p. 229.

Figure 1: The Interactive Effects of Force and Importance of Freedom



(From Brem and Brehm, op. cit., n. 16, p. 229)

want.¹⁸ We do not get this negative information if it is the rewards of the market that control us; we do if it is a regulator who seeks to control us through rewards. Hence we can expect the invisible hand of the market to generate less reactance than the visible hand of a controlling regulator. The more important the freedom being regulated, the greater this reactance effect will be according to the evidence generated by this theory.

While the theory explains why reactance to regulatory rewards should be greater than reactance to rewards in markets, and therefore why rewards should be less effective than we might expect in making regulation work, reactance theory does not explain why regulatory rewards should be less useful than punishment. For that result we turn to responsive regulatory theory.

RESPONSIVENESS

A more fundamental policy debate about regulatory strategy than that between reward and punishment has been the contest between punishment and persuasion. My own position in that debate, and that of quite a number of others, is that it is best to have a presumption in favour of trying persuasion first, generally reserving punishment for when persuasion fails.¹⁹ Persuasion is cheaper and a more respectful way of treating the regulated actor. However, it is argued that persuasion will normally only be more effective than punishment in securing compliance when the persuasion is backed up by punishment. The idea of responsive regulation grew from dissatisfaction with the business regulation debate – some arguing that business people are rational actors who only understand the bottom line and who therefore must be punished consistently for their law breaking, others that business people are responsible citizens and can be persuaded to come into compliance. In different contexts there is a lot of truth in both positions. This means that both consistent punishment and consistent persuasion are foolish strategies. The hard question is how do we decide when to punish and when to persuade.²⁰ What makes the question such a difficult one is that attempts to regulate conduct do not simply succeed or fail. Often they backfire, making compliance with the law a lot worse.²¹ So the tragedy of

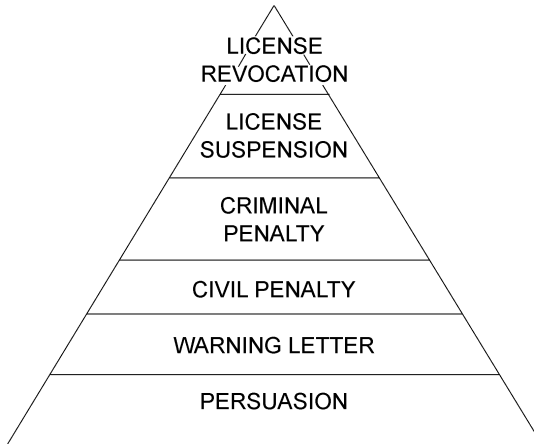
18 T. Tyler, *Why People Obey the Law* (1990); T. Tyler and R.M. Dawes, 'Fairness in Groups: Comparing the Self-Interest and Social Identity Perspectives' in *Psychological Perspectives on Justice: Theory and Applications*, eds. B.A. Mellers and J. Baron (1993); T. Tyler and S. Blader, *Cooperation in Groups: Procedural Justice, Social Identity, and Behavioral Engagement* (2000); T. Tyler and Y.J. Huo, *Trust and the Rule of Law: A Law-Abidingness Model of Social Control* (2001).

19 Ayres and Braithwaite, op. cit., n. 11; N. Gunningham and P. Grabosky, *Smart Regulation: Designing Environmental Policy* (1998).

20 J. Braithwaite, *To Punish or Persuade: Enforcement of Coal Mine Safety* (1985).

21 L.W. Sherman, 'Defiance, Deterrence and Irrelevance: A Theory of the Criminal Sanction' (1993) 30 *J. of Research in Crime and Delinquency* 445–73.

Figure 2: An Example of a Regulatory Pyramid



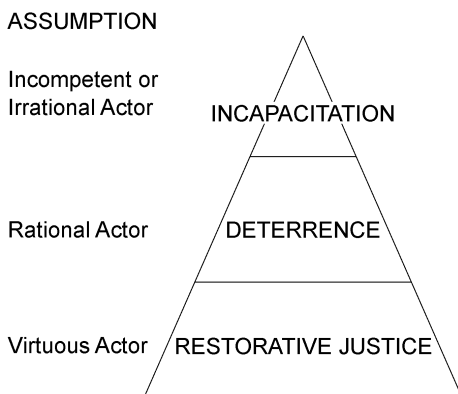
consistent punishment of wrongdoers of a certain type is that our consistency will regularly cause us to make things worse for future victims of the wrongdoing. In business regulation circles these days, there is not much contesting of the conclusion that consistent punishment of business non-compliance would be a bad policy, and that persuasion is normally the better way to go when there is reason to suspect that cooperation with attempting to secure compliance will be forthcoming.

The most distinctive part of responsive regulation is the regulatory pyramid. It is an attempt to solve the puzzle of when to punish and when to persuade. At the base of the pyramid is the most restorative dialogue-based approach we can craft for securing compliance with a just law. As we move up the pyramid, more and more demanding and punitive interventions in peoples' lives are involved. The idea of the pyramid is that our presumption should always be to start at the base of the pyramid, then escalate to somewhat punitive approaches only reluctantly and only when dialogue falls, and then escalate to even more punitive approaches only when the more modest forms of punishment fail. Figure 2 is an example of a responsive business regulatory pyramid from Ayres and Braithwaite.²² The regulator here escalates with the recalcitrant company from persuasion to a warning to civil penalties to criminal penalties and ultimately to corporate capital punishment – permanently revoking the company's licence to operate

If it is right, as responsive regulation claims, that cooperative approaches such as education, persuasion, and restorative justice are normally better,

22 Ayres and Braithwaite, *op. cit.*, n. 11, p. 35.

Figure 3: Toward an Integration of Restorative, Deterrent, and Incapacitive Justice



though not invariably so, as a first strategy, then regulators are best to be presumptively cooperative and only override this presumption when strong reasons to do so appear.²³ When the cooperative approach fails, the regulator escalates up the pyramid. According to the theory, this escalation involves an abandonment of the motivational assumption that the regulated actor is a responsible citizen who is capable of complying (see Figure 3). The next port of call assumes the regulatee to be a rational actor who must be deterred. But of course if the regulatee is a rational firm, it can be motivated by reward just as well as, or better than, by punishment. The problem with a responsive regulatory strategy that would have the regulator escalate from trust and cooperation to reward is moral hazard. The regulatee who really is a rational actor will exploit the opportunity a first preference for trust provides by failing to invest in compliance. Then such a firm will reap the rewards for compliance provided at the next rung up the pyramid. Unpunished free riding followed by rewarded free riding. Escalation to punishment is what is needed to provide incentives for the rational actor to invest in cooperation and risk management.

So why not make reward the first port of call at the base of the pyramid? One reason is that paying rewards is more expensive than asking for voluntary compliance. Second, rewards commonly cause reactance, as we saw in the last section. Third, as we saw in the first section, rewards foster a culture of game playing. Game playing is productive in the context of a

23 Responsive regulation moreover argues that this approach is best even with hardened law-breakers. The most irresponsible of us has a socially responsible self. Responsive regulation is a strategy for persuading the worst of us to put our best self forward.

market; in the context of regulation, games of cat and mouse tend to be expensive, inefficient, and result in a win for the corporate cat, defeating the purposes of the regulation.²⁴ From the theoretical perspective of responsive regulation, putting rewards at the base of the pyramid creates the wrong kind of regulatory culture,²⁵ the wrong kind of regulatory community.²⁶ It would give business the message that they are not expected to be responsible corporate citizens. The policy framework would give the message that government only expects corporations to meet their obligations when it pays. The moral content of the law is eroded²⁷ as nobler motives are eclipsed by baser ones.²⁸

Finally, attempts to replace punishment with reward in a regulatory pyramid tend to be illusory. For example, an environmental strategy of rewarding reductions in a certain kind of effluent requires reporting of the fact of such reductions unless the state is going to employ an inspector to be present at the factory measuring effluent every day. The reward strategy thus introduces incentives to cheat on reporting, to say that more effluent has been eliminated than is the case. So a new inspectorate is needed to catch and punish rational effluent cheats. The effect of the reward strategy is to replace environmental inspectors with fraud auditors or tax inspectors. This is a bad outcome because financial auditors are technically incompetent to do the diagnostic trouble-shooting of environmental problems which is among the most effective things environmental inspectors do.²⁹

All of that said, there are some conditions where rewards at the base of an enforcement pyramid work well and deliver the economic efficiency advantages of a market for regulatory outcomes contrived by the regulator. One of those conditions is that non-compliance is so transparent that financial auditors are not needed.³⁰ For example, the policy many governments introduced in the late 1970s and 1980s of reducing taxes on unleaded fuel was part of a package that successfully reduced lead in the environment.³¹ While there was some cheating by petroleum suppliers, it

24 E. Bardach and R.A. Kagan, *Going by the Book: The Problem of Regulatory Unreasonableness* (1982); R.A. Kagan and L. Axelrad, *Regulatory Encounters: Multinational Corporations and American Adversarial Legalism* (2000).

25 C. Parker, *The Open Corporation* (forthcoming).

26 E. Meidinger, 'Regulatory Culture: A Theoretical Outline' (1986) 9 *Law and Policy* 355–86.

27 J. Braithwaite, 'The Limits of Economism in Controlling Harmful Corporate Conduct' (1981–82) 6 *Law and Society Rev.* 48–504.

28 R. Goodin, 'Making Moral Incentives Pay' (1980) 12 *Policy Sciences* 131, at 139–40.

29 Bardach and Kagan, op. cit., n. 24; K. Hawkins, *Environment and Enforcement: Regulation and the Social Definition of Pollution* (1984); Gunningham and Grabosky, op. cit., n. 19; B.M. Hutter, *A Reader in Environmental Law* (1999).

30 C. Coglianese and D. Lazer, 'Management-Based Regulatory Strategies', Regulatory Policy Program Working Paper RPP-2001-09, Harvard University (2001).

31 Gunningham and Grabosky, op. cit., n. 19, p. 435.

was limited by the fact that putting the wrong kind of fuel in certain kinds of engines would cause problems for consumers. In other words, there was sufficient transparency for the regime to be self-enforcing in the market. A second condition this case meets is of a large imbalance of power between regulator and regulatee in favour of the regulator. Here the regulatee is primarily the motor-vehicle user: they pay the tax, not the motor-vehicle manufacturer. If it were the motor-vehicle manufacturer that was provided with an opportunity to reduce tax on a large scale, we might have seen regulatory cat and mouse in the engineering of motor vehicles in pursuit of that tax benefit. But most of us did not have the economic or technological capability to re-engineer our motor vehicles in pursuit of tax advantages. We were simply too weak (economically and technically) in comparison with the state's power, so we just went along with the regime and took the rewards in the way intended by the policy makers. Another example of successful regulation by reward was the provision in 1999 by the Australian government of a tax rebate for joining a private health insurance fund. This worked in reversing the desertion of Australians from private health insurance, which had been putting a huge burden on the public system. It worked because, like the fuel tax, it was a modest reward to individuals of modest means. In contrast, we know that if we make available a large tax rebate to economically powerful actors, they will hire tax lawyers and accountants to financially engineer the target of the rebate. If research and development expenditure attracts a tax break, companies find ways of interpreting the cleaning of their office floors as R&D on cleaning fluids! If making films is something governments want to reward to assert local culture over the power of Hollywood, then as we have seen in Australia, New Zealand, the United Kingdom, and Canada, film tax shelters proliferate based on films that never illuminate a screen. As Grabosky³² points out, beyond the risk of inefficacy, there is the risk that tax incentives that are 'back door expenditures' are less subject to scrutiny, blowing out to levels vastly beyond the initial policy justification before anyone notices. This is also one of the reasons, Grabosky argues, that regulation by reward increases distributive inequities. The same dependency mentality as a disincentive to innovation as can be applied to individual welfare dependency can be applied to corporate dependency on state handouts, only with more worrying distributive implications.³³

Even where these two conditions of transparency and regulatee weakness are met, a third condition needed is an absence of weapons of the weak. In most contexts, for example, piece rates to motivate factory workers to produce more, do not work very well. The reason is that workers conspire to self-regulate limits on rates of production that will maximize their income for minimum effort. 'Rate-busters' are punished by ostracism. This

32 Grabosky, *op. cit.*, n. 3, p. 10.

33 *id.*, p. 13.

ostracism has proven a most effective weapon of the weak against regulation by reward.

Where these conditions are not met, there is a risk that reward at the base of the pyramid can not only fail, but can make the problem worse. For example, if you pay farmers bounties to plant trees in pursuit of a biodiversity objective,³⁴ you had better be sure your monitoring of the number of trees on large properties is credible (something more possible with satellite technology). If not, you create incentives to cut down and sell trees in order to gain the bounty from subsequently replanting the area. If you pay for blood instead of relying on voluntary donations to the Red Cross, there is more to worry about than simply eroding altruism and voluntarism.³⁵ There is also the worry that the unscrupulous will get hold of HIV- or hepatitis-infected blood destined for destruction and divert it to the commercial market in blood. At the more structural level, perverse incentives can be an even more massive problem. If our regulatory policies were to become more inured to regulation by reward, corporate power would be used on a variety of fronts to drive up problems so there can be a bigger pay-off for reducing them. For example, a good strategy for power companies has been to increase their use of dirty coal stocks as they lobby for a regime of rewards to switch to clean coal and non-coal power generation.

SALVAGING REWARD

My conclusion that rewards in markets are effective in shaping behaviour implies that indirect regulatory strategies which have the effect of enhancing market rewards for desired behaviour can be effective. Hence green labelling, mandated disclosure of the fuel efficiency of motor vehicles, and other mandatory disclosure rules can achieve regulatory objectives by enabling consumers to supply rewards in the market for desired behaviour. Of course, the outcomes specified on green labels still have to be easily measured, which they can be with fuel efficiency but not with most environmental impacts.

A form of reward that seems to have unequivocally positive effects on compliance is informal praise – inspectors giving a word of encouragement when they see an improvement. Makkai and Braithwaite³⁶ found that when nursing homes were monitored by inspection teams that used a lot of praise, subsequent compliance with quality of care standards

34 *id.*, pp. 7–8.

35 R.M. Titmuss, *The Gift Relationship* (1971).

36 T. Makkai and J. Braithwaite, 'Praise, Pride and Corporate Compliance' (1993) 21 *International J. of the Sociology of Law* 73–91.

improved, after controlling for other factors. Makkai and Braithwaite therefore went on to commend other slightly more formal forms of praise such as letters from local members of Congress congratulating homes that achieved excellence in quality of care (which we often observed to be framed in nursing home lobbies) and the State of New York Department of Health's practice of putting out a press release on a regular basis announcing the names of nursing homes found to be totally free of deficiencies.

Praise is a gift. It is not required. Like a smile, it is supererogatory. While a smile of approval can motivate us enormously, because it has the character of a gift more than that of a reward, we do not normally interpret it as an attempt to manipulate us. So there is mostly not a reactance problem, not a problem of extrinsic incentive driving out intrinsic satisfaction in doing the right thing. Informal praise is compatible with cooperative problem solving at the base of a regulatory pyramid. The more voluntary compliance is elicited at the base of the pyramid, the more fulsome the praise dispensed. When there has been non-compliance that moved regulation up the pyramid, the return to compliance and movement back down the pyramid can be associated with praise for putting things right. Hence, while punishment is associated with movement up the pyramid, praise is associated with movement down. In practice there does not seem to be much of a problem of regulatees being non-compliant so they can get the benefit of informal praise in a sequence following formal punishment. This is because the power of praise does not reside so much in it being a reward that can be balanced against the cost of punishment. Its power resides in the affirmation of identities – law abiding identities in the case of regulation – communicated by praise.

CONCLUSION

Punishment is not the most important lever of compliance in a responsive regulatory framework. However, we have argued here that it is in most contexts a more useful tool than reward. The form of direct regulatory reward that avoids persistent dangers of counterproductivity is informal praise. And it works because it is not seen as a conscious reward by regulated actors, at least not when it is communicated with finesse. Extrinsic rewards undermine intrinsic motivation, and foster game playing and defiance in response to attempts at control. Punishment as an escalation up a regulatory pyramid combats free riding, reward exacerbates it. Reward not only increases the danger of risks being uncontrolled, but provides reason to increase risk if subsequent reward is calibrated in proportion to the degree to which risks are brought under control. Reward therefore must only be used at the base of a regulatory pyramid and in association with movements down the pyramid. Even then, informal praise of the person oriented to affirming

his or her identity as a responsible citizen is more useful than monetary rewards. Praise projects encounters into the rhetoric of obligation, monetary rewards into calculative game playing that strips norms of their moral content.