ENFORCEMENT POLICY AND CORPORATE MISCONDUCT: THE CHANGING PERSPECTIVE OF DETERRENCE THEORY

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I

INTRODUCTION

Stephen Calkins' article, which draws on his considerable experience in navigating through the legal system, provides an impressive road map of many critical issues currently facing the system.[1] Should corporate misconduct be controlled through criminal or administrative penalty procedures? Should these procedures focus on entities or on individuals? Should the goal be deterrence or compensation of harms? My comments will sketch a few additional landmarks onto this road map from a researcher's perspective, drawing primarily on my two decades of empirical research on deterrence theory.

I hope to convey some of the interesting policy implications of recent deterrence research. Many people still think that deterrence models focus exclusively on the use of legal penalties to control clearly defined misconduct perpetrated by fully informed, rational corporations. However, more recent analyses attempt to identify the relative costs and benefits associated with alternative enforcement strategies in typical complex settings like those described by Calkins. This research continues to focus on economic efficiency, but now incorporates broader institutional and motivational analyses in order to understand the increasingly complex institutional structures and policy objectives involved in mitigating a growing range of social harms.

I will begin with a brief discussion of the simple deterrence model, which still provides a powerful analytic tool for the conditions that match its assumptions. I will then describe the extensions developed during the past two decades that address the following issues: (1) bounded rationality and the problem of corporate errors; (2) ambiguity of rules and cooperative enforcement; (3) collective action and voluntary compliance; and (4) prosecutorial discretion and the accountability of enforcement agencies. Each of these issues has quite different implications for the theory of deterrence as well as for the practical is-

This article is also available at http://www.law.duke.edu/journals/lcp.

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1. *See* Stephen Calkins, *Corporate Compliance and the Antitrust Agencies' Bi-Modal Penalties*, 60 LAW & CONTEMP. PROBS. 127 (Summer 1997).

sues of designing a legal system based on individual versus entity liability, criminal versus administrative sanctions, and punishment versus compensation.

II

THE SIMPLE DETERRENCE MODEL

Bentham's original deterrence calculus argued that compliance with the law was dependent on increasing the pain associated with getting caught to the point that it canceled out the pleasures and profits associated with breaking the law. The economic models developed by Becker, Stigler, and Posner provided a powerful restatement of this calculus in the framework of microeconomic theory.[2] The application of these early deterrence models to corporate misconduct relied on four simplifying assumptions in order to define the critical enforcement problem: (1) corporations are fully-informed utility maximizers; (2) legal statutes unambiguously define misbehavior; (3) legal punishment provides the primary incentive for corporate compliance; and (4) enforcement agencies optimally detect and punish misbehavior, given available resources. These assumptions allowed the use of powerful microeconomic models that produced clear implications for setting optimal penalties, optimal detection strategies, and optimal statutes given optimal compliance rates.

The appeal of these early models extended beyond the powerful policy tools they provided and well beyond the intentions of the authors, for they fit well with the popular morality play so often portrayed in movies of America's western frontier. Greedy black-hatted bad guys imposed costly social harms on innocent citizens until the white-hatted sheriff established laws and coerced the bad guys to behave. The application of this model to greedy corporations imposing health, safety, and environmental harms on society was a common feature, ironically, of anti-market public interest groups; these groups demanded the creation of well-armed regulatory agencies to counter-balance corporate power and deter corporate misbehavior.

When I began my research on regulatory enforcement and compliance two decades ago, I believed that these models were powerful enough to explain most of the important features of regulatory compliance and enforcement policies. I still believe that they are very important in the conditions corresponding to the initial assumptions—where individuals and corporations are motivated primarily by legal penalties and where laws are clear and legitimate. However, I am now convinced that the four assumptions capture a very small, albeit important, part of a much larger picture.

My own quest for more satisfactory assumptions was driven primarily by puzzles that arose in my empirical tests of deterrence models, as illustrated by the following four examples.

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2. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (1986); Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968); George J. Stigler, *The Optimum Enforcement of Laws*, 78 J. POL. ECON. 526 (1970).

1. Workplace safety in plants inspected by OSHA improves after penalties are imposed. Surprisingly, however, the size of the penalty has little impact on safety improvements, contradicting the basic premise of deterrence theory that large expected penalties explain compliance.[3]

2. Deterrence-oriented strategies are less effective in reducing workplace injuries than cooperative enforcement strategies that use punishments less frequently but more intensively.[4]

3. Taxpayers' fears of being caught if they cheat have no relationship to objective risks,[5] and have less impact on compliance than do taxpayers' trust in government and the duty to pay taxes.[6] Trust and duty respond predictably to government behavior.[7]

4. The intensity of enforcement activities varies across jurisdictions and time to satisfy local and national political demands.[8]

These puzzles illustrate anomalies associated with each of the four simplifying deterrence assumptions previously listed. Each extension focuses on a different problem in controlling corporate misconduct from the first list, and each has different implications for the design of legal systems and enforcement policy. The following sections discuss extensions of each assumption that have developed during the past two decades to explain these anomalies.

III

BOUNDED RATIONALITY AND THE PROBLEM OF CORPORATE ERRORS

One modest extension of deterrence theory incorporates the assumption that the function of the legal system is to keep the risk of social harms arising from inevitable corporate mistakes within tolerable limits. This function, and the problems in pursuing it, is perhaps most evident in the actions of regulatory

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3. *See generally* John T. Scholz & Wayne B. Gray, *OSHA Enforcement and Workplace Injuries: A Behavioral Approach to Risk Assessment*, 3 J. RISK & UNCERTAINTY 283 (1990).

4. *See generally* John T. Scholz, *Cooperative Regulatory Enforcement and the Politics of Administrative Effectiveness*, 85 AM. POL. SCI. REV. 115 (1991).

5. *See generally* John T. Scholz & Neil Pinney, *Duty, Fear, and Tax Compliance: The Heuristic Basis of Citizenship Behavior*, 39 AM. J. POL. SCI. 490 (1995).

6. *See generally* John T. Scholz & Mark Lubell, *Trust and Taxpaying: Testing the Heuristic Approach to Collective Action*, 42 AM. J. POL. SCI. 398 (1998).

7. *See generally* John T. Scholz & Mark Lubell, *Adaptive Political Attitudes: Duty, Trust, and Fear as Monitors of Tax Policy*, 42 AM. J. POL. SCI. (forthcoming June 1998).

8. *See generally* John T. Scholz & B. Dan Wood, *Controlling the IRS: Principals, Principles, and Public Administration*, 42 AM. J. POL. SCI. 141 (1998); John T. Scholz et al., *Street-level Political Controls over Federal Bureaucracy*, 85 AM. POL. SCI. REV. 829 (1991).

agencies overseeing nuclear and airline safety, where the potential social harm from corporate errors are widely recognized. However, error correction plays an important and under-appreciated role even in the mundane, daily enforcement practices of most regulatory agencies.

Consider the first empirical puzzle noted above, the common finding that the probability of detection deters illegal behavior, but that the size of punishment does not seem to matter—at least not in the normal range of administrative punishments imposed by regulatory agencies. Gray and Scholz suggest that inspections imposing penalties result in improved safety because they focus managerial attention on risks that may otherwise have been overlooked.[9] It is not the miniscule penalty that makes OSHA inspections effective in reducing injuries, but rather the concern of managers to prevent the costs associated with accidents once they are aware of the risks.

This bounded rationality perspective emphasizes the limited ability of corporations to achieve the goals they desire. Busy managers have neither the time, capability, knowledge, nor information required to maximize corporate utility, but rather "satisfice" by choosing familiar alternatives that are good enough for the current situation.[10] While managers cope with problems causing the most immediate concern, the level of risk in other areas can reach levels that a fully informed manager would want to avoid. Safety records improve after inspections that cite hazardous conditions for the same reason that safety increases after major accidents—because then management resolves problems that were overlooked while management was concerned elsewhere. These errors are particularly likely when the signs of increasing risk are infrequent and difficult to interpret, as is the case with low-frequency, high-cost risks. The issues with the most ambiguous signs of risk frequently involve safety, health, and environmental harms that are not clearly reflected in costs—that is, the very issues that impose the greatest externality problems that regulatory policies attempt to resolve.

Of course, successful organizations install error-detection systems to reduce exposure to known risks in a cost-effective manner, and insurance companies provide a redundant source of safety standards and monitoring to control their clients' exposure to loss claims. Public agency monitoring and safety standards add an additional level of redundancy, one that generally has very different emphases from the systems of corporations and their insurers. Each error-detection system is itself prone to failure, but redundant systems enhance the likelihood that potentially catastrophic errors are detected and the corresponding harms are prevented even if the corporate system fails.[11]

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9. *See* Scholz & Gray, *supra* note 3, at 286.

10. *See generally* RICHARD M. CYERT & JAMES G. MARCH, A BEHAVIORAL THEORY OF THE FIRM (1963).

11. For the general theory of redundancy applied to organizations, see C.F. LARRY HEIMANN, ACCEPTABLE RISKS: POLITICS, POLICY, AND RISKY TECHNOLOGIES (1997); Martin Landau, *Redundancy, Rationality, and the Problem of Duplication and Overlap,* 29 PUB. ADMIN. REV. 346 (1969); *see also* ROSS E. CHEIT, SETTING SAFETY STANDARDS: REGULATION IN THE PUBLIC AND PRIVATE

Thus, the appropriate criteria for assessing the error correction function of the legal system include: (1) the reversibility and ability to compensate for social harm (for example, simple monetary losses as compared with death or permanent environmental degradation); (2) the likelihood that corporate error would produce the harm; (3) the potential reduction in probability or seriousness of harm that public monitors could produce; and (4) the direct and indirect costs imposed by the public system.

The error-correction perspective attempts to "correct" corporate conduct by reducing corporate mistakes that even corporations want to avoid. It emphasizes the potential weakness in the liability approach due to tragic corporate mistakes. To reduce these mistakes, the perspective suggests policy solutions that bolster the self-monitoring and error-correction mechanisms in corporations, third-parties (insurers, underwriters, etc.), or public monitors for situations when private systems appear most prone to error.

As an example of the policy implications of the error-correction perspective, consider the mundane issue of workplace safety. Since mistakes from inattention produce greater risk of harm, liability incentives sufficient to provide a socially desirable level of safety in the most error-prone firms would result in over-protection in the less error-prone firms. For example, mid-sized workplaces generally have the greatest preventable safety problems. A level of workers' compensation liability that is adequate for these workplaces would result in over-investment in safety by better-managed firms. Rather than raising liability, it therefore may be more efficient to target OSHA inspections on the most error-prone firms to correct for the lessened impact of liability and insurance incentives.[12]

The least understood problem from this perspective involves innovative corporate activities whose social harms are discovered only after new products are introduced or new processes adopted. The innovation's economic potential generally is discovered long before the potential social harms are known; knowledge about the social harm and efficient methods of preventing it is frequently a public good, and therefore tends to be under-produced. Policy solutions attempt to impose adequate incentives for corporations to develop knowledge of potential harms through pre-market approval mechanisms (for example, the FDA requirements for prescription drugs) and the threat of enhanced class action litigation.[13]

SECTORS (1990) (comparing public and private systems); CHARLES PERROW, NORMAL ACCIDENTS: LIVING WITH HIGH-RISK TECHNOLOGIES (1984) (discussing the limitations on reliability in preventing major catastrophes); John T. Scholz, *Reliability, Responsiveness, and Regulatory Policy*, 44 PUB. ADMIN. REV. 145 (1984) (providing an extended presentation relevant to enforcement and regulation).

12. The importance of adequate targeting strategies for enforcement actions is discussed in Wayne B. Gray & John T. Scholz, *Analyzing the Equity and Efficiency of OSHA Enforcement*, 13 LAW & POL'Y 185 (1991).

13. *See* Jill E. Fisch, *Class Action Reform,* Qui Tam, *and the Role of the Plaintiff*, 60 LAW & CONTEMP. PROBS. 167 (Autumn 1997).

The redundancy principle suggests that multiple knowledge-generating systems may provide a less error-prone social learning mechanism than reliance on even a well-motivated corporation. Third-party insurers, consultants, and regulatory agencies all develop specialized expertise based on overlapping but quite different sets of experience, each with a different potential for discovering patterns of harms that the individuals suffering the harms could not detect. One of the least appreciated, and probably least developed, aspects of regulatory inspections and the promulgation of new regulations is the potential for providing an independent social learning mechanism and for accelerating the diffusion of harm-reduction technologies.[14]

IV

THE AMBIGUITY OF RULES AND COOPERATIVE ENFORCEMENT

A. Rules

The simple deterrence model is most appropriate when legal statutes unambiguously define corporate misbehavior. However, rules are seldom capable of defining the exact behavior desired of corporations, particularly when the desired level involves a balance between harms produced, costs imposed, and economic activities foregone.[15] Rules uniformly applied to broad classes of situations cannot readily take advantage of better alternatives available to control harms in specific situations. A rule that makes an optimal tradeoff nationally between harms prevented and costs imposed generally will be sub-optimal locally, imposing requirements that are overly stringent in some settings and overly lax in others. As a practical matter, rules that are written to be clear to the managers who must implement them may lack the enforceability important to prosecutors or the detailed specification required by safety engineers.

Because of the inherent weaknesses in using rules to control corporate behavior, the deterrence goal of securing compliance to rules is of secondary importance to achieving the purpose that the rules are designed to achieve. Generally, rules are used to achieve a more desirable balance of harms, costs, and economic activities than is achieved by market outcomes. Successful deterrence techniques that achieved full compliance simply would exacerbate the inefficiencies inherent in rules.

B. Cooperative Enforcement

Cooperative enforcement techniques, on the other hand, can reduce the inevitable inefficiencies of rules by allowing local tradeoffs on a case-by-case basis. For example, the EPA could allow an innovative firm to use newly devel-

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14. *See* Scholz, *supra* note 11, at 150.

15. *See generally* EUGENE BARDACH & ROBERT A. KAGAN, GOING BY THE BOOK: THE PROBLEM OF REGULATORY UNREASONABLENESS (1982); PHILLIPE NONET & PHILIP SELZNICK, LAW AND SOCIETY IN TRANSITION: TOWARD RESPONSIVE LAW (1978).

oped cost-saving technology to control emissions as long as the new technique reduced emissions by more than the legally required technology.[16] Practically every inspection encounters potential tradeoffs that could reduce both the levels of harm that concern the agency and the compliance costs that concern the corporation. Minor violations can be overlooked in return for more effective actions that reduce greater harms at lower costs.

The problem, of course, is that enforcement agencies and regulated firms alike are tempted to take advantage of the other. Inspectors and prosecutors can insist on costly corrections of all violations even after the corporation took voluntary action that reduced overall harms by far more than could be accomplished by full compliance. In fact, the deterrence model implicitly encourages this behavior. Corporations can take advantage of cooperative inspectors, however, by exaggerating claims of harm reduction and disguising the extent of noncompliance and potential flaws in their voluntary actions. Thus, both sides face a dilemma in which cooperation could leave each better off than the deterrence outcome, but both sides are tempted to cheat on the other to gain an even more favorable outcome. Both sides also fear getting stuck with the sucker's payoff if the other side takes advantage of their cooperative actions.

As in the well-known prisoners' dilemma, cooperative solutions to the enforcement dilemma are possible as long as the gains in cooperation from expected future encounters are greater than the current temptation to cheat. Whenever the future is sufficiently important, an enforcement agency strategy with the characteristics of "tit-for-tat" (cooperate initially, then do what the other side did in the previous round) is capable of maintaining cooperation.[17]

Observers of regulatory enforcement have routinely noted that some agencies follow practices that have the tit-for-tat characteristics of niceness (overlook minor violations when overall compliance in critical areas is high), vengefulness (hit uncooperative, intentional violators with big penalties), and forgivingness (reestablish cooperation once a troublesome corporation has demonstrated good faith).[18] Indeed, one study has shown empirically that OSHA jurisdictions following this cooperative strategy reduce workplace injuries more efficiently than jurisdictions following a less flexible deterrence-based approach.[19]

Cooperative enforcement emphasizes a different set of issues than the deterrence model.

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16. *See* John T. Scholz, *Cooperation, Deterrence, and the Ecology of Regulatory Enforcement,* 18 LAW & SOC'Y REV. 179, 185 (1984).

17. *See generally* ROBERT M. AXELROD, THE EVOLUTION OF COOPERATION (1984) (discussing cooperation); Scholz, *supra* note 16, at 188 (analyzing cooperative enforcement).

18. *See generally* IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE (1992); BARDACH & KAGAN, *supra* note 15; ENFORCING REGULATION (Keith O. Hawkins & John M. Thomas eds., 1984).

19. *See* Scholz, *supra* note 4.

1. Big Penalties. As Calkins emphasized, big penalties are of critical importance to gain the cooperation of recalcitrant corporations. In addition, the size of the biggest credible threat determines the bargaining power of the agency to secure reduced harms from all cooperating firms. Whether criminal or administrative in nature, the size of the biggest penalties must be sufficiently large to overcome any short-term temptation to cheat.

2. The Penalty Pyramid. A range of penalties allows agencies to escalate the enforcement threat gradually when uncertainties about the good faith of the corporation require some penalty response. Given that corporations and agencies may erroneously perceive non-cooperation in the action of the other, intermediate levels of punishment may provide a cushion to re-establish cooperation more rapidly when minor conflicts arise. Cooperative enforcement requires an array of punishments ranging from frequently imposed minor penalties at the base of the punishment pyramid to the seldom-imposed major penalties at the apex.[20]

3. Prosecutorial Discretion. The gains from cooperative enforcement are based on the ability of the inspector to trade off stringent enforcement in return for additional reductions in harm at the plant level. Enforcers must be able to "avoid both the mistake of selecting a sledge hammer to swat a fly and selecting a flyswatter to stop a charging bull."[21] The cooperative enforcement model in part is based on the deterrence model's assumption of a well-intended and capable enforcement agency. Much of the literature critiquing the strategy of cooperative enforcement denies the validity of this assumption, as discussed in Part VI on enforcement accountability.

4. Coordinated Enforcement Strategies. The profusion of local, state, and federal agencies with overlapping enforcement authority creates a problem for the development of cooperative strategies; the threat of a single, deterrence-oriented prosecutor can undermine the incentive of the corporation to cooperate with any of the other agencies. If deterrence were the only goal, then the "externalities" of one agency's prosecutions that Calkins discusses can only enhance deterrence. However, coordination of enforcement becomes increasingly important in gaining the benefits of cooperative enforcement.

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20. *See* AYRES & BRAITHWAITE, *supra* note 18, at 38-41.
21. *Id.* at 52.

Without cooperative enforcement, *ex ante* control of corporate behavior through the enforcement of rules is best limited to situations in which there is sufficient expertise and consensus to create behavioral standards that are at once efficient, practical, and enforceable. Cooperative enforcement provides some of the flexibility normally associated with *ex post*, liability-based control of corporate behavior. The liability system does not rely on rules enforced by a government agency to deter corporate misconduct *ex ante* but rather holds corporations responsible for damages they cause *ex post*. As with the liability system, cooperative enforcement requires that the principles behind the rules are applied flexibly, and that enforcement agencies and corporations accept the procedures established to legitimate the decisionmaking process. As discussed in the next two sections, the importance of legitimacy is not recognized by the deterrence model.

V

GOVERNMENT AS FACILITATOR AND GUARANTOR OF AGREEMENTS: COLLECTIVE ACTION AND VOLUNTARY COMPLIANCE

The deterrence model reflects a common assumption that rules are imposed on corporations against their wishes, and, therefore, that legal penalties provide the primary motivation to counterbalance the profitability of misconduct. The model does not consider the more subtle relationship that occurs when corporations stand to gain if all corporations obey the law, but each corporation individually benefits if they can free ride.

Tax collection provides perhaps the clearest and most important illustration of this collective action problem. Consider a society in which all taxpayers would be better off if all paid their taxes and enjoyed the collective benefits from public goods supported by taxes. Individually, however, each taxpayer would be better off cheating on taxes and free-riding on the contributions of the other taxpayers. Conventional wisdom and deterrence models frequently assume that only fear of the IRS will keep "rational" taxpayers from free-riding in such situations.

However, empirical research on the federal income tax consistently has found that a sense of duty to pay taxes is at least as important as fear in predicting compliance.[22] As noted above, one study found that taxpayers' subjective beliefs about the likelihood of getting caught were completely unrelated to objective risks that the IRS could detect cheating.[23] If fear is unrelated to enforcement strategies, then enhanced enforcement cannot deter cheating.

Studies by Scholz and Lubell provide evidence that taxpayers' compliance strategies are more intelligent than the free-riding strategy assumed in deter-

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22. For a general review, see PANEL ON TAXPAYER COMPLIANCE RES., NAT'L RES. COUNCIL, TAXPAYER COMPLIANCE: VOLUME 1: AN AGENDA FOR RESEARCH (Jeffrey A. Roth et al. eds., 1989).

23. *See generally* Scholz & Pinney, *supra* note 5.

rence theory.[24] They show that compliance increases as trust toward the government and toward the honesty of other citizens increases, and also that trust and the sense of duty to pay taxes honestly increase when government policies (specifically the 1986 Tax Reform Act) prove to be beneficial to the taxpayer. In other words, taxpayers are willing to pay taxes *contingent on* the behavior of the government and other citizens.[25] Unlike the free-riding strategy, contingent compliance allows taxpayers to gain the advantage of cooperation in the provision of public goods, but at the same time protects them against exploitation by political elites or by free-riding taxpayers. The IRS supports contingent compliance not by deterring each taxpayer, but rather by providing credible assurances that other taxpayers are complying.

The collective action perspective has become increasingly relevant in modern economies where corporations and consumers alike rely on a complex array of public and private institutions to provide cost-effective assurances about the integrity of producers and merchants.[26] The assurance role of the legal system is perhaps clearest in the regulatory actions of agencies like the Securities and Exchange Commission and the Food and Drug Administration, where regulated firms as a whole gain with the expansion of trade made possible by credible markets. In these as well as in other less obvious market situations, each firm is tempted to free ride on the credibility established by competitors who obey laws and market regulations. The integrity of the market, like the integrity of the tax system, depends on the ability of public and private institutions to control the temptation for individual firms to take advantage of the system.

When corporations (like taxpayers in the previous example) share the collective benefits from the law, deterrence alone provides too narrow a basis for designing the legal system. As Chester Bowles observed of compliance with price controls during World War II, most companies will go along with regulations perceived to benefit the market as long as the enforcement agency makes a credible effort to identify and punish the small group of hardcore noncompliers.[27] "Voluntary compliance" by the majority is a contingent strategy that gains the benefits of cooperation for the compliers as long as they can be assured that others are not taking undue advantage of their compliance. Yet cooperation in dynamic economic settings is always a fragile condition that requires constant maintenance. This maintenance relies to a great extent on self-enforcement and self-regulation by the industry, particularly for established laws and accepted practices.[28]

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24. *See generally* Scholz & Lubell, *supra* note 6; Scholz & Lubell, *supra* note 7.

25. For a general discussion and historical case studies illustrating the strategy of contingent compliance, see MARGARET LEVI, OF RULE AND REVENUE (1988).

26. *See generally* DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE (1990) (expanding the transaction cost analysis of contracts and exchange pioneered by Ronald H. Coase and developed by Oliver E. Williamson).

27. *See generally* CHESTER BOWLES, PROMISES TO KEEP: MY YEARS IN PUBLIC LIFE, 1941-1969 (1971).

28. *See generally* Robert E. Lane, *Why Businessmen Violate the Law, in* WHITE COLLAR CRIMINAL 88 (Gilbert Geis ed., 1968).

Even when private institutions provide the primary motivation for compliance, public institutions are required to fill two critical functions in support of voluntary compliance.[29] First, public institutions provide an arena to debate, reinterpret, and legitimize changes in the standards of corporate conduct required in a dynamic economy. All firms in a market potentially can benefit from standards that enhance credibility, reduce transaction costs, and hence expand the gains of specialization and trade. But seldom will any individual firm be sufficiently motivated by this gain to pay the costs necessary to develop a new standard and gain the agreement of others. Even if dominant corporations or trade associations overcome this initial collective action problem, some of the firms among both buyers and sellers in the market inevitably will gain more than others from any given standard. Without a public forum capable of imposing an agreement, the costs and difficulties of negotiating agreements among multiple trade associations would reduce the likelihood and extent of agreement. By expanding the interests involved in defining the standards, a public forum can broaden the social benefits achieved through compliance with the resultant standard. By maintaining a site for continuous discussion and consideration, a public forum can provide added flexibility to reinterpret standards on the fly as changing conditions rapidly undermine the usefulness of previous definitions of corporate misconduct.

The function of establishing and reinterpreting standards is served by public institutions ranging from highly specialized regulatory agencies that follow well-specified rulemaking procedures to the generalized system of prosecutors and courts that reinterpret rules by deciding cases that set new precedents. The strengths and weaknesses of a given public institution in resolving a particular type of collective action problem can be evaluated in terms of the actors affected by the problem, the gains and losses for each actor associated with potential agreements, and the transaction costs that provide an obstacle to agreement.

The second critical function of public institutions in supporting voluntary compliance is to bolster incentives to cooperate through enforcement actions. Supporting voluntary compliance requires more subtle policies than deterrence-oriented enforcement optimally calculated to deter free-riding. Although we know surprisingly little about this support function of public enforcement, the following suggestions merit further consideration, debate, and experimentation.

1. *Limit Criminal Sanctions to Egregious Cases.* The Lynch article in this volume argue that criminal sanctions should be limited to situations involving blameworthiness and widely accepted definitions of egregious behavior.[30] The collective action perspective suggests that this limitation may be important to

29. The two functions are discussed in John T. Scholz & Wayne B. Gray, *Can Government Facilitate Cooperation? An Informational Model of OSHA Enforcement*, 41 AM. J. POL. SCI. 693 (1997).

30. *See generally* Gerard E. Lynch, *The Role of Criminal Law in Policing Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 23 (Summer 1997).

preserve the normative basis and consensual nature of voluntary compliance. As Lane noted some time ago, shared norms and beliefs about legitimacy provide an important basis for business relationships, because shared beliefs and attitudes are important to sustain cooperative solutions.[31] Imposing criminal sanctions where necessary may be critical for sustaining shared beliefs, while expanding criminal sanctions too rapidly may undercut them. Non-criminal penalties commensurate with the harms to be prevented may provide a better motivational tool in settings where blameworthiness is controversial.

2. *Improve Procedural Fairness.* Tom Tyler's studies have found that perceptions of procedural fairness are at least as important as the objective outcomes in determining compliance by individuals with court orders.[32] The perception of fair treatment and due process enhanced compliance even when orders imposed considerable costs. If perceptions of fairness support voluntary compliance by corporations as well, then agency procedures should be designed to enhance perceptions of fairness and to convince corporations of the legitimacy and positive benefits from the law being enforced.[33]

3. *Revise Inadequate Rules.* Since voluntary compliance rests on the collective advantages gained if rules are followed, rules that are perceived to be illegitimate because they provide no collective advantage will weaken support for voluntary compliance. The enforcement process can compensate partially for inadequate rules by not enforcing rules when they are inappropriate, as noted in the discussion on cooperative enforcement. Even better, enforcement programs can include procedures to revise inadequate rules discovered during the enforcement process.[34] Unfortunately, the organizational separation of enforcement and rulemaking functions in most agencies has diminished the ability of field experience to revise inadequate rules.

4. *Target Enforcement at "Bad Apples."* Perhaps the greatest challenge for enforcement agencies is to maintain adequate vigil and impose sufficient fines to deter recidivist non-compliers while treating voluntary compliers with greater deference. A critical task for targeting enforcement is to focus attention on the weakest links in private or self-policing systems. Inadequate

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31. *See* Lane, *supra* note 28, at 95. For a general discussion of the role of norms and culture in preserving cooperative solutions to collective action problems, see RUSSELL HARDIN, COLLECTIVE ACTION (1982). For a more technical game theoretic discussion, see Randall L. Calvert, *Rational Actors, Equilibrium, and Social Institutions*, *in* MODERN POLITICAL ECONOMY 216 (Jeffrey S. Banks & Eric A. Hanushek eds., 1995); David M. Kreps, *Corporate Culture and Economic Theory*, *in* PERSPECTIVES ON POSITIVE POLITICAL ECONOMY 90 (James E. Alt & Kenneth A. Shepsle eds., 1990).

32. *See generally* TOM TYLER, WHY PEOPLE OBEY THE LAW (1990).

33. *See, e.g.*, Robert A. Kagan & John T. Scholz, *The "Criminology of the Corporation" and Regulatory Enforcement Strategies*, *in* ENFORCING REGULATION 67, 72-74 (Keith O. Hawkins & John M. Thomas eds., 1984).

34. For a description of an enforcement process that routinely revises inadequate rules, see ROBERT A. KAGAN, REGULATORY JUSTICE: IMPLEMENTING A WAGE-PRICE FREEZE (1978).

enforcement in these settings destroys the credibility on which cooperation and voluntary compliance is based.

5. *Strengthen and Encourage Private Enforcement Systems*. The more credible the private enforcement systems, the less the burden on public systems to provide assurances that those who voluntarily comply will receive the expected collective benefit. Trade associations can monitor members, and corporations can monitor their competitors, sub-units, and employees more efficiently than can public agencies. When corporate monitors are not fully credible, as in the case of workplace safety, public monitors may be used to provide assurances necessary for the maintenance of voluntary compliance.[35] When trade associations or corporations can detect misbehavior but lack the means to punish it, as in the case of misbehavior by competitors, enforcement agencies can use complaints to find the "bad apples."

When corporations have the means of punishing subordinates for illegal behavior, punishing the corporation rather than individuals responsible for wrongdoing may serve to strengthen the corporation's private enforcement system. Criminal prosecution of individuals will be necessary, however, whenever the potential gains to the individual from illegal behavior far exceed the worst punishment the firm could impose, as Calkins notes.[36]

Arlen and Kraakman have stimulated an important debate on alternative corporate liability strategies designed to enhance the self-policing system within corporations.[37] Calkins is not persuaded by their argument that the presence of adequate corporate compliance programs should reduce liability when wrongdoing is detected, at least within the domain of Fair Trade Practices.[38] He argues that compliance programs are inherently inadequate if they fail to prevent misconduct, and that recalcitrant corporations will establish sham compliance programs to take advantage of reduced liability.[39] The simple deterrence model would support Calkins' concerns. The collective action perspective, on the other hand, suggests that policy innovations to encourage efficient self-policing deserve serious evaluation for their potential to enhance voluntary compliance.

VI

PROSECUTORIAL DISCRETION AND THE ACCOUNTABILITY OF ENFORCEMENT AGENCIES

Perhaps the greatest challenge and least understood aspect of controlling corporate misconduct involves the behavior of the public enforcement agencies

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35. *See* Scholz & Gray, *supra* note 29, at 703-04.
36. *See* Calkins, *supra* note 1, at 141-43.
37. *See generally* Jennifer Arlen & Reiner Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687 (1997).
38. *See* Calkins, *supra* note 1, at 147-49.
39. *See id*.

designed to define and control misconduct. The simple deterrence model avoids this issue, although economic models of regulation frequently emphasize the adverse impact of organized political interests on regulatory agencies.[40]

As noted earlier, empirical studies confirm the conventional wisdom that agencies adjust enforcement behavior in response to changes and variation in their political environments—specialized federal regulatory agencies like OSHA even step up enforcement actions in Democratic counties in comparison to Republican ones.[41] Given the range of tasks for public institutions, we need to understand the motivations of public agencies and incorporate this understanding in the design of public enforcement institutions.

To illustrate the problem, consider the deterrence model's prediction that an increase in speeding fines will decrease speeding. If we add the assumption that police are motivated to decrease their enforcement effort, however, the extended model can show that the amount of speeding will remain constant and only the number of tickets issued will decrease.[42] Similarly, if we assume that business interests can bribe or cajole inspectors, the model of cooperative enforcement discussed above leads not to more efficient reduction in harms, but rather to less enforcement.[43]

The problem of ensuring the accountability of enforcement agencies is as widely recognized as it is poorly understood. Mistrust of agency discretion, as noted earlier, appears to be the primary reason why groups who benefit from a policy prefer deterrence-oriented enforcement even when cooperative enforcement leads to greater benefits.[44] Policy beneficiaries insist on non-discretionary "if you see it, cite it" enforcement of clear standards.

The more efficient approaches to corporate control discussed above are dependent on the development of credible accountability mechanisms to provide assurances that the potential gains will be achieved. The four accountability mechanisms listed below impose external reviews on the agencies:

> 1. Formal Procedural Requirements. From state-level Blue Skies and Sunshine Acts to the federal Government Performance and Review Act and the Clinton Administration's National Performance Review, legislation defines formal procedures and requirements that regulatory agencies must follow. Despite the frequency of use, the

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40. Among the earliest works are Gary S. Becker, *Public Policies, Pressure Groups, and Dead Weight Costs* 28 J. PUB. ECON. 329 (1985); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

41. *See* Scholz et al., *supra* note 8, at 844.

42. *See* George Tsebelis, *The Abuse of Probability Analysis: The Robinson Crusoe Fallacy*, 83 AM. POL. SCI. REV. 77, 82 (1989).

43. *See* Scholz, *supra* note 16, at 216.

44. *See* Scholz, *supra* note 4, at 121-22, 128-29. The implications for enforcement strategies are discussed in John T. Scholz, *Political Education is Necessary to Foster Cooperative Regulatory Enforcement, in* CORPORATE LAWBREAKING AND INTERACTIVE COMPLIANCE 141, 149 (Jay A. Sigler & Joseph E. Murphy eds., 1991).

> effectiveness and costs of these formal procedures are not well established.
>
> 2. Legislative and Executive Oversight. Agency activities are reviewed by established legislative oversight committees as well as by agencies like the Office of Management and Budget and the General Accounting Office. Oversight focuses primarily on general policy rather than on enforcement problems, and appears to be limited to the most salient public issues.
>
> 3. Independent Commissions and External Boards. Independent management is intended to increase the political independence and expertise of agencies.
>
> 4. Interest Representation. Agencies are required to encourage participation of public interest groups to balance the influence of regulated corporations in the regulatory process.

These external accountability mechanisms and their limitations are familiar. Internal accountability mechanisms, on the other hand, are less familiar but may have greater untapped potential for providing the broader assurances required for enhancing the effectiveness of enforcers to encourage voluntary compliance. Kaufman catalogues organizational procedures used to control the discretion of field officers that range from report-writing requirements and managerial reviews of subordinate behavior to training program manuals that codify standard decision rules.[45] Bardach and Kagan describe managerial techniques for balancing the need of accountability with the flexibility required to pursue cooperative enforcement techniques and enhance voluntary compliance.[46] Elsewhere in this volume, Lynch recommends an extended dialogue among prosecutors as an informal means of standardizing the criteria used by prosecutors to apply criminal sanctions in novel situations.[47]

Internal control mechanisms currently employed by enforcement agencies generally restrict the discretion of field officers in an attempt to enhance simple deterrence. However, these mechanisms could be redesigned to channel enhanced discretion in ways that contribute to social learning, cooperative enforcement, and voluntary compliance. Understanding the possibilities and limitations of internal accountability mechanisms is a critical ingredient for designing more effective institutions to reshape corporate activities.

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45. *See generally* HERBERT KAUFMAN, THE FOREST RANGER (1960).
46. *See* BARDACH & KAGAN, *supra* note 15, at 152-83.
47. *See* Lynch, *supra* note 30, at 63-65.

VII

CONCLUSION

The law and economics approach featured in this essay rejects the notion that misconduct is primarily a simple matter of right and wrong to be controlled by deterring misconduct. The design of legal institutions is premised on the broader goal of channeling corporate behavior in ways that enhance the general welfare. To achieve this goal, the basic assumptions of the simple deterrence model—fully informed corporations, unambiguous rules, legal penalties, and well-behaved enforcement agencies—need to be extended in the directions discussed above.

My goal is not to confirm or contradict the specific conclusions of the Calkins article, but rather to provide four additional perspectives for considering the important issues he raises. Policy debates can seldom be settled conclusively when considered from only one perspective. Each perspective emphasizes different problems, with policy implications that may conflict with implications from the other perspectives. As Calkins' essay demonstrates, the appropriate assumptions for analyzing any given problem depend on the particular characteristics of the problem and on the relative strengths and weaknesses of institutions involved in the problem setting. Designing public institutions and policies to deal with the problems of corporate error correction, cooperative enforcement, voluntary compliance, and agency accountability deserve the serious attention of practitioners and scholars alike.