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Robust Enforcement Should Complement Voluntary Regulation

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In the wake of the 2008 financial crisis, the Securities and Exchange Commission (SEC) abruptly halted its voluntary supervision program, which had allowed investment banks to largely police themselves. In Congressional testimony, Chairman Christopher Cox offered this blunt assessment: “voluntary regulation does not work.” Yet the U.S. Chamber of Commerce and many industry groups continue to maintain that government enforcement activities discourage firms from self-policing and self-reporting regulatory violations, and that, in contrast, voluntary regulation motivates firms to comply with government regulations. These opposing views frame the policy debate as an either-or choice between government enforcement and voluntary regulation. In contrast, our research on the Environmental Protection Agency’s (EPA) Audit Policy¹ suggests voluntary programs and robust yet judicious regulatory enforcement can be effective complements rather than substitutes.

Spurred by the anti-regulation movement that started in the 1970s, voluntary self-regulation programs have emerged in many regulatory agencies, seeking to increase cooperation between government and industry to achieve greater and more cost-effective compliance. “Beyond compliance” programs like the EPA’s *Project XL* and OSHA’s *Voluntary Protection Program* recognize and reward firms for practices that go above and beyond the requirements of the law. “Self-policing” programs adopted by several agencies shift the burden of monitoring regulatory compliance and reporting noncompliance from the government to the private sector. The U.S. Department of Justice, the Department of Defense, and the Securities and Exchange Commission all offer incentives, ranging from confidentiality to amnesty, to encourage companies to police themselves and reveal fraud and other illegal behavior.

The story often told about these programs in policy circles is that they offer a win-win-win scenario: compliance improves, regulators conserve enforcement resources, and firms save money. But these outcomes are only achieved if the self-regulatory activities of corporations

¹ See Jodi L. Short and Michael W. Toffel, “Coerced Confessions: Self-Policing in the Shadow of the Regulator,” *Journal of Law, Economics and Organization* 24:45 (2008); Jodi L. Short and Michael W. Toffel, “Making Self-Regulation More than Merely Symbolic: The Critical Role of the Legal Environment,” *Administrative Science Quarterly* 55:361 (2010); Michael W. Toffel and Jodi L. Short, “Coming Clean and Cleaning Up: Does Voluntary Self-Reporting Indicate Effective Self-Policing?” *Journal of Law and Economics* 54:361 (2011).

can effectively substitute for government enforcement, a largely untested assumption that our research examines. We find that, to the contrary, the success of voluntary regulation is, in fact, contingent on a robust regime of government inspection and enforcement. Within such a regime, we find that voluntary compliance efforts by regulated firms can in fact improve their environmental performance. The upshot is that polarized claims that corporate voluntary regulation is either a “win-win” or a “lose-lose” proposition are misguided. The key to efficient and effective regulatory design is finding the right mix of public and private regulatory activities.

THE KEY ROLE OF GOVERNMENT ENFORCEMENT

To determine when and why voluntary programs improve compliance with government regulations, we examined the EPA’s Audit Policy. Launched in 1995, the Audit Policy is a voluntary program that encourages firms to self-disclose compliance violations found during their internal environmental compliance audits. Like many voluntary programs, the Audit Policy encourages participation by offering benefits to participants, namely reduced or waived penalties for violations that are promptly disclosed, as long as the violations are not severe. The EPA also promises not to use internal environmental audit reports as a basis for civil or criminal investigations. However, unlike many other voluntary programs, the Audit Policy also imposes conditions on its promised benefits: namely, self-disclosers must remediate their violations and commit to maintaining ongoing, systematic internal auditing procedures.

Examining violations self-disclosed by 3,500 industrial facilities from 1997-2003, we find that robust government enforcement promotes effective voluntary regulation. First, facilities are more likely to self-report violations and commit to ongoing self-policing when they are subject to frequent EPA inspections, targeted by one of EPA’s focused compliance initiatives, or even subject to enforcement litigation. Thus, it is government surveillance and enforcement that prompts firms to adopt self-policing in the first place.

Second, once firms have committed to police themselves, they are more likely to do so effectively when they and other firms in their industry are closely monitored by regulators. Our results demonstrated that self-policing firms that are themselves heavily inspected or that are in industries that are heavily inspected are more likely to improve their compliance records, evidence that they were following through on their voluntary commitments to self-regulate. This suggests that firms take their voluntary regulation commitments more seriously when regulators are more likely to catch them shirking.

LIMITS OF GOVERNMENT ENFORCEMENT

While governmental monitoring and enforcement activities promote the adoption and efficacy of corporate self-regulation, other types of enforcement tools appear to dampen the incentives for firms to adopt and succeed at self-regulation. For instance, in one of our studies, we found that fewer firms self-reported and committed to self-policing in states that failed to provide immunity from liability for voluntarily disclosed violations. Firms appear to need some assurance that their voluntary cooperation with EPA will not be met with adversarial action by state regulators. By contrast, we found that state-level “audit privileges”—guarantees that firms can conceal information related to self-reported violations—had no effect on disclosure rates. Thus, allowing firms the more limited protection of immunity for specific self-reported violations, but without allowing firms to shield information about voluntarily reported violations by invoking an audit privilege, appears to be sufficient to encourage self-disclosure while maintaining public access to important information regarding health, safety, and the environment.

Second, while close government monitoring promotes effective self-policing, direct enforcement threats foster less genuine commitments to self-police. In some of its compliance programs, for example, the EPA threatens to subject firms to greater enforcement if they fail to disclose violations and agree to prospective internal compliance auditing. Companies that disclosed violations under such enforcement threats were less likely to follow through on their commitments to conduct internal auditing, and failed to improve compliance after making such commitments.

WHO WINS? THE POSSIBILITIES AND LIMITS OF VOLUNTARY REGULATION

Self-regulation can produce positive results, but it is no free lunch. Corporate voluntary compliance programs can, under certain circumstances, produce better compliance. In addition, it appears that firms that disclosed violations to EPA reaped a significant reward: regulators’ trust. We found that regulators inspected voluntary disclosers less frequently after these firms disclosed. However, better compliance appears to remain contingent on a significant investment of inspection and enforcement resources by regulators.

The success of voluntary regulation depends not only on government monitoring intensity, enforcement threats, and statutory immunity provisions, but also on firm characteristics. Specifically, voluntary regulation is virtually doomed to fail when adopted by firms with troubled compliance histories. In our study, facilities with a poor track record of compliance were much less likely to follow through on their commitments to self-regulate than those that had strong compliance records. This suggests that although self-regulation may be a useful tool for enhancing the compliance of high-capacity firms, it is of limited use as a strategy for reforming struggling or recalcitrant companies.

REFRAMING THE DEBATE

Contradicting the conventional wisdom that self-regulation can serve as an effective substitute for enforcement measures, we find that government enforcement of regulations is a key driver of effective voluntary regulation. Not only does enforcement prompt firms to adopt voluntary regulation programs in the first place, but the expectation of continued enforcement leads firms to follow through on commitments issued in the course of voluntary regulation programs, which drives compliance improvement.

The regulatory policy debate needs to be reframed to recognize that voluntary regulation is neither a panacea nor a reckless guise. Our research on the EPA's Audit Policy indicates that voluntary regulation can work when accompanied by robust, routine government enforcement, but will fail when prompted by threats or adopted by firms with poor compliance records. Regulatory policy should recognize that continued government regulation is a critical element to voluntary regulation. But at the same time, by tailoring their enforcement practices, regulators can tap into benefits of internal compliance auditing.