Designing Responsive Regulatory Institutions, 2 The Responsive Community 41 (1992) (with John Braithwaite).

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The most fundamental question in the design of any institution is whether it should be designed for knaves, as counseled by Hobbes and Hume, or whether it should assume that citizens will be virtuous. Geoffrey Brennan and Hames Buchanan, in The Reason of Rules, argue for institutions that economize on virtue because the harm inflicted by those who behave worst will not be compensated for by the "good" done by those who behave better than average.

Brennan and Buchanan assume that these worst-case actors will be rationally nonvirtuous. Hence, the solution lies with market institutions that are constituted so as to aggregate the self-interested rationality of the nonvirtuous to nevertheless achieve virtuous ends.

Can we then build into the micro foundations of our theories of institutional design the assumption that citizens will be virtuous? Do we design institutions on the assumption that actors will be rational economic actors? Our thesis is that we should decidedly not do any of these things. We should not design institutions based on motivational assumptions that are static. Dynamic institutional design that is responsive to multiple and changing human motivations will serve us best.

The trouble with institutions that assume people will not be virtuous is that they destroy virtue. American agencies that regulate business tend to do just this. Braithwaite has observed the tragic little drama of virtue-being-destroyed many times during his empirical research on business regulation. The government inspector marches into a workplace and starts making threats; citations are written; most critically, both the demeanor of the inspector and the policy that stands behind that demeanor communicate the expectation that the manager on the receiving end of the encounter is untrustworthy. The regulator communicates the assumption that it is only compulsion, or only the bottom line, that will move the manager to submit to the policy of the law. But this assumption is often wrong. The safety manager may deeply care about the safety of her workers, and she resents, bitterly resents, being treated as if she does not care. This resentment can destroy her good faith, her willingness to go an extra mile beyond what the inspector asks her to do. Common sense and a wealth of experimental psychological research instructs us that when human beings are compelled to do something, their commitment to doing it erodes. More precisely, commitment erodes in comparison with a situation in which they voluntarily choose to do that thing because they are persuaded that it is the right thing to do.

Instead of institutions that economize on virtue, we need institutions that give actors space to be virtuous. Regulatory institutions can be designed to nurture rather than destroy civic virtue in the business community. At the same time, we need tough- minded regulatory institutions that can shift to a hardheaded approach when virtue fails, as it often will.

Hence, we favor regulatory institutions that first attempt to solve problems by persuasion and dialogue, that open regulatory interactions with an assumption of good- faith commitment to implement the spirit of the law, even if this goes beyond the letter of the law. When this fails, regulatory response should escalate to deterrent threats of increasing severity that progressively shift the motivational assumption from the desire to be law-abiding to the desire to protect the bottom line.

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