Legislative Threats

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A Theory of Legislative Threats

ABSTRACT

The Article presents a theory of legislative threats that pierces the fundamental concept of the legal system as a regulatory institution and more generally as a mechanism of social governance. It examines ten case studies that demonstrate the use of legislative threats in diverse areas of law and social policy. Conceptually, legislative threats encompass a variety of threats that legislators exert on firms and financial institutions, organizations and institutional shareholders, professions and industrial sectors, universities and public institutions, federal agencies, and possibly even U.S. states, according to which legislators will exercise their legislative mandate and enact adverse legislation in order to regulate the conduct or condition in question, unless the recipients of the threat alter their behavior so as to bring it in line with the legislators’ demands (Implicit in the threat is the inverse promise that the legislators will forgo the threatened legislation if, and only if the recipients of the threat comply with the demands). The Article also offers an analytic taxonomy of threats that includes explicit, implicit, and anticipatory legislative threats.

Using non-cooperative game-theory, the Article models the strategic interaction between legislators and threat-recipients and generates predictions concerning the inducement effect of legislative threats on behavior. Specifically, the analysis considers conditions that may render threats credible, including (i) legislators’ pre-game commitment; (ii) legislators’ reputation; and (iii) legislators’ emotional motivations. The analysis also examines (i) the effects of the probabilistic nature of legislative threats; (ii) the effects of imperfect and asymmetric information on the threat’s inducement effects; (iii) the effects of legislative threats on the properties of regulatory bargaining in the shadow of the threat (e.g., the magnitude of transaction costs, information revelation, and degree of contractual incompleteness); and (iv) the effects of strategic interaction within homogenous and heterogeneous as well as organized and unorganized groups on threat-induced compliance.

The Article considers the effects of legislative threats on (i) social control efficacy and (ii) democratic and constitutional legitimacy. To that end, the analysis highlights functional and institutional considerations pertaining, respectively, to the comparative capacity of legislative threats to effectively control behavior in an increasingly-complex and information-intensive social reality; and to various political, constitutional, and democratic implications arising from the use of legislative threats. Functional considerations include: (i) the asymmetric information of social planners and its effects on social control; (ii) the superiority of threat-induced self-regulation of conduct compared with “top down” regulation of conduct; (iii) the capacity of threat-induced self-regulation to accommodate rapidly-changing demands of social control; and (iv) the effects of threat-induced self-regulation on reducing the costs of law enforcement. In this respect, the analysis advances the following claim: legislative threats can be viewed as a spontaneous response to the institutionally-handicapped position of lawmakers and to the limits of the law in effectively controlling social activities; to that end, legislative threats are designed to reduce information and transaction costs of policy-making and regulatory bargaining. Institutional considerations encompass ways in which the use of legislative threats enables legislators and regulators to evade procedural safeguards, institutional constraints, and substantive controls designed to limit the power to make law and effect policy changes. These considerations are based upon the following observations: (i) using legislative threats, legislators opt-out of the “rules of the game,” disenfranchise fellow legislators, and are therefore able to effect policy changes notwithstanding a possible lack of majoritarian support; (ii) legislative threats disenfranchise the executive branch by preventing a possible presidential veto and by sidestepping the government’s role in law enforcement; (iii) legislative threats disenfranchise the states by redrawing the federal-state allocation of regulatory powers; (iv) legislative threats bypass constitutional safeguards by evading judicial review of statutes; and (v) legislative threats disenfranchise the judiciary by circumventing precedent-setting interpretation of statutes.

The Article argues that notwithstanding the superior functional capacity of legislative threats to control behavior in an increasingly-complex and information-intensive society, the institutionally-unregulated and politically-unaccountable use of implicit and explicit threats poses formidable normative challenges for the most treasured attributes of American constitutional democracy. On balance, it seems that even though the benefits of legislative threats may exceed their short-term cost (thus becoming efficient in the short-term), in the long-term the reverse is true, thus suggesting that the best domain of legislative threats consists, in fact, of an empty set. For, any increase in individual well-being and aggregate social welfare—due to the improved efficacy of social control—is inevitably outweighed by a higher commensurate decrease in well-being and social welfare, reflecting in turn the toll of violating constitutional and democratic principles; the negative impact on societal stability and the disincentive on private investment; and the consequential decline in economic growth. In turn, the discussion develops a social control scheme that is rooted in the province of legislation and is designed to ensure the socially-optimal trade-off between regulatory efficacy and the toll on democratic accountability, namely: an outcome-oriented or risk-focused, deferred-implementation, contingent sunset legislation.

Lastly, the Article argues that the exponential increase in the complexity of activities and the rapid changes in behavior across all social domains are two major sources of growth-driven social instability. Paradoxically, absent effective social control, the processes that drive well-developed market economies towards economic growth and
social progress, may ultimately propel their economic decline, increase social instability, and lead to their gradual societal deterioration. Thus, the more advanced a society becomes the more demanding is the lawmakers’ role. Viewed from this perspective, the emergence of legislative threats—though institutionally illegitimate and socially unwarranted—demonstrates the limits of law and the severe limitations of lawmakers. Moreover, they underscore the growing incapacity of the legal system to deliver its pre-eminent promise: to maintain ordered liberty and to promote sound public policies. Viewed from an ever broader perspective, the widespread use of legislative threats demonstrates an increasing tendency towards (what I label) a second-order social control system, where legislators establish second-order rules designed to create the incentives necessary to induce entities and groups to adopt socially-desired rules of conduct. Inevitably, the trend toward second-order social control diminishes the traditionally-extensive role of the regulatory state, but increases the power of groups that, in shaping their regulatory environment, practically turn into islands of self-regulation.
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INTRODUCTION

As first-year law students, we are introduced to universal and fundamental truisms about the nature of the legal system and its role in establishing and maintaining the social order.\(^1\) One such truism, or so we are taught, is that the legal system, defined as the “coercive order of public rules addressed to rational persons for the purpose of regulating their conduct,” is designed to guide and control social behavior.\(^2\) We are also taught that in order to perform this age-old function, the legal system relies upon well-established sources of law, including statutes and opinions, from which legal norms originate.\(^3\) Legal norms, so the truism goes, control the behavior of individuals and the conduct of firms, organizations, and the government and its agencies.\(^4\)

These seemingly-universal truisms have never been questioned nor have they ever been subject to rigorous theoretical examination. Notwithstanding the credence that the conventional view of the legal system has been afforded over the years, the most fundamental question—namely, is the conventional view descriptive of and coextensive with how modern social control actually works?—seems to have escaped critical examination.\(^5\)

I believe there are several explanations for why, to date, this question has neither been posed nor thoroughly studied. The principal reason is that legal scholarship tends to focus somewhat disproportionately on the work of the judiciary, driven by the implicit assumption that courts are the prime social control institution in the overall design of the legal system.\(^6\) In keeping, Richard Posner notes that “[t]he trouble started with Holmes’s well-known characterization of the judge as an interstitial legislator,

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\(^1\) Maintaining order counts as the prime objective of all societies and groups because, as evolution theorist Robert Ardrey observed, “[n]either the population explosion nor the density of urban populations, neither nuclear catastrophe nor the devious adventures of youth, represents a threat to our civilized future quite so perplexing as man’s propensity for the violent way.” See Robert Ardrey, The Social Contract: A Personal Inquiry into the Evolutionary Sources of Order and Disorder 253-54 (1970).

\(^2\) These fundamental, long-standing truisms are not only inculcated to first-year law students but, given their basic role in the functioning of the legal system, they seem to lie outside the realm of scholarly criticism and intellectual inquiry. Similar statements on the nature of the legal system and the role of statutes and cases are also found in Jane C. Ginsburg, Legal Methods: Cases and Materials 1-19 (1996) (discussing the origins, nature, and authority of case-law and the attributes and types of legislation). See also E. Allan Farnsworth, An Introduction to the Legal System of the United States 47-60, 61-71 (3d ed., 1996) (statutory law is the end-product of the legislative process and is used to control social behavior).

\(^3\) “[B]y enacting statutes, making regulations, giving judgments, etc., norms are created.” See Joseph Raz, The Concept of a Legal System 70 (1980). Norms originating from these sources satisfy the “chain of validity” criterion. Id. at 105 (“A law belongs to a given system if, and only if, it is either part of the first constitution or has been enacted by the exercise of powers directly or indirectly conferred by it”).

\(^4\) To that end, the legal system employs civil and criminal as well as private and public law enforcement mechanisms that are designed to ensure deterrence. See Steven Shavell, Foundations of Economic Analysis of Law 474-78, 571-90 (2004). See also Charles Fried & David Rosenberg, Making Tort Law: What Should be Done and Who Should Do It 16-22 (2003) (the liability system should be designed to achieve optimal incentives).

\(^5\) A plethora of theories have been offered to examine the type and scope of social activities that merit social control. For example, political economic theories suggest that legislators ought to control activities provided that they are consequential to social welfare. Importantly, however, such theories only explain or prescribe the role of legislators as social planners and policy-makers but do not address the pivotal question that is the subject-matter of the present inquiry, which is, how legislators effectuate control social behavior.

which Cardozo echoes in the *Nature of the Judicial Process*.”7 Furthermore, even when legislation *is* the focus of the inquiry, the intellectual enterprise engages issues that lie on the outer boundary of the legislative process or where legislation interacts with the judicial process, rather than on *how* the legislative process in and of itself serves the function of social control. Indeed, many studies focus on issues relating to statutory construction and normative constraints on legislative power (e.g., delegation, the void-for-vagueness doctrine, and *ex post facto* legislation).8 Moreover, the landscape of modern civil litigation in the U.S. further reinforces the scholarly over-emphasis of the judiciary’s social control function. The confluence of collectivized and large-scale litigation—including class actions and informal aggregation of numerous claimants into a single legal proceeding—where judges and attorneys fashion complex global settlements,9 militate in favor of the view that courts, not legislatures, play a major role in modern social control.10 And, reinforcing this view, commentators have analogized class action settlements to *ad hoc* administrative agencies,11 and class action attorneys to lawmakers.12

The question raised earlier—namely, does the conventional view of the legal system adequately account for how modern social control actually works?—lies at the center of this Article. The *theory of legislative threats* I present in this Article casts doubt over the validity of the seemingly-absolute truisms that permeate the conventional wisdom. This analysis pierces the fundamental concept of the legal system as a regulatory institution and, more generally, as a mechanism of social governance. Contrary to the conventional view, this theory demonstrates that the *threat of formal legislation*—rather than the legislation itself—plays a formidable role in controlling social behavior, in creating the underlying incentives, and in maintaining the existing social order. More precisely, the theoretical propositions I advance in this Article subvert the long-standing premises on which modern legal systems rest concerning, in particular, the role of legislation and legal norms in controlling activity across diverse domains of

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7 See Richard A. Posner, *So What Has Pragmatism to Offer Law?*, in *OVERCOMING LAW* 387, 392 (1995) (“[D]espite realist effort to refocus legal scholarship from common law to the emergent world of statute law, legislation proved a challenge to which the realist tradition … was unable to rise”).


9 See William B. Rubenstein, *A Transactional Model of Adjudication*, 89 GEO. L.J. 371 (2001) (large class action lawsuits are essentially large commercial transactions in which attorneys’ activities are business-oriented; pleadings do not initiate adjudication but succeed the finalization of the transaction; judges broker deals, they do not adjudicate cases; and the desire for nationwide deals displace boundaries on the judicial function).

10 See Jack B. Weinstein, *Individual Justice In Mass Tort Litigations: The Effect of Class Actions, Consolidations, and Other Multiparty Devices* 102-104 (1999) (judges in mass tort litigation are significantly involved in settlement discussions and resolution of cases); Judith Resnik, *Managerial Judges*, 96 HARV. L. REV. 374 (1982) (federal judges have departed from blindfold disengagement to adopt an active, “managerial” approach according to which they negotiate with parties and work beyond the public view and are out of reach of appellate review).


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modern society. In turn, however, this Article offers a theory of social control and regulation of conduct that is rooted in reality, rather than rests precariously on idealized premises and bygone truisms. As such, the theory offers explanatory value and predictive power.

As conceptualized in this Article, legislative threats encompass a variety of threats that legislators exert on firms and financial institutions, organizations and institutional shareholders, professions and industrial sectors, universities and public institutions, federal agencies, and possibly even U.S. states. According to these threats, legislators will exercise their legislative mandate and enact adverse legislation in order to regulate the conduct or condition in question, unless the recipients of the threat alter their behavior so as to bring it in line with the legislators’ demands. Implicit in the threat is the inverse promise that the legislators will forgo the threatened legislation if, and only if the recipients of the threat comply with the demands. Under certain conditions, legislative threats induce these entities to modify their conduct and abandon certain practices so as to avert the risk of unfavorable legislation. Legislative threats thus describe an unaccounted-for mechanism which legislators frequently use to exercise their institutional power to control social conduct and to effect public policy.

The inducement effect of legislative threats explains therefore ubiquitous instances in which firms announce—what at a first glance may seem to be—a voluntary adoption of socially-desirable policies or banning of existing, socially-harmful practices.

Evidently, the theoretical inquiry implicates important societal interests and high social stakes because legislative threats are used to control diverse activities, the consequences of which are vital to social welfare. Specifically, legislative threats are observed and play an important role in regulating environmental hazards and in managing risks to health; in enhancing the security standards of Internet commerce and in reducing the risks of e-piracy to consumers; in mitigating the risks of cyber attacks by terrorists; and in enhancing consumer protection from product risks. Legislative threats are also employed to reshape the responsibilities and functioning of corporate boards; to induce banks and financial institutions to monitor and detect money laundering and help deter organized crimes; and to curtail the use of steroids and illegal substances in professional sports. In general, legislative threats are employed to effect policy reforms

13 Legislative threats, providing an informal, unregulated source from which “legal norms” originate, are distinctly contrasted with canonical conceptions of the legal system and the well-established sources of law. For a discussion of the sources of law see generally the classic works of John Chipman Gray, The Nature and Sources of the Law (2d ed. 1921) and Hans Kelsen, General Theory of Law and State (1945).

14 References to legislators and legislation incorporate regulators and regulations, respectively. While important distinctions exist (e.g., authority, hierarchy), these have no analytic bearing on the arguments presently made. In fact, highlighting these distinctions would only limit the high level of generality and the broad applicability of the thesis. Unless otherwise noted, legislation and regulation are used interchangeably.

15 See, e.g., James Moore, SLI Urges Joint Action to Keep Boards True, THE TIMES, Jan. 2, 2003, at 23 (“Trade bodies including ... the National Association of Pension Funds and the Investment Managers Association released a new code of practice on shareholder activism ... designed to head off the threat of legislation aimed at forcing shareholders to take a more active role in the companies in which they invest”); Bob Alexander, Options for House of Lords Reform, THE TIMES, Feb. 6, 2003 (“[E]ither ... the threat of legislation hangs over the [profession] as an incentive to reform. Otherwise self-interest prevails”).
where a given conduct or condition is associated with negative externalities. Hence, the effects of legislative threats on social welfare cannot be underestimated.

Puzzlingly, while legislative threats provide a remarkably-powerful social control mechanism, this phenomenon has gone virtually unnoticed and thus far, has remained unaccounted for on both theoretical and normative grounds. This Article not only fills this significant gap in the current understanding of political institutions and policy-making dynamics, but should also bring about a sea-change in how we think about the inner workings of legislatures and the informal and often less visible practices of legislators. Overall, the theory of legislative threats offers a sharp and compelling conceptual departure from the conventional thinking on law and social control.

Lest there be any doubt, legislative threats are not merely a conceptual novelty, one created by academic intellectualism and whose applicability is limited to the unruly world of ideas. The theoretical inquiry examines ten case studies that are drawn from diverse social context, thus revealing how legislators actually go about doing their business. These case studies demonstrate the pervasive use of legislative threats and their role as a regulatory mechanism. These observations therefore help decipher the subtle way, often not sufficiently visible to the public eye, in which legislators exercise their political mandate to control social behavior and to make public policy. Their combined weight lays down veritable foundations that are necessary to sustain one of the theory’s positive arguments—legislators, without an existing institutional mandate or legitimate constitutional authority, employ legislative threats to opt-out of the lawmaking processes and bring about policy and regulatory changes.

Generalizing from these cases, the theoretical claims offer an incisive, novel account of the ways in which legislators and other lawmaking officials actually control social behavior; the counter-intuitive role the legal system and formal legal norms play in facilitating threats, and thereby in regulating and guiding conduct; and the forces that work in reality to define the regulatory environment and societal framework in which social activities take place. Uncovering the use of legislative threats, the theory posits that such threats introduce a de facto (albeit, not a de jure) source from which norms originate. And, as legislative threats have become increasingly widespread, an extensive “body” of norms—to which I refer as invisible law—has gradually emerged. This Article exposes this set of “norms,” crafted and devised in compliance with institutionally-unregulated an politically-accountable threats to use legislative power.

Unlike visible and formal legal norms (e.g., statutes, regulations), however, informal legislative threats control individual behavior and regulate the conduct of entities by threatening to use legislative power, rather than by using that power to introduce formal legislative measures. The unregulated use of threats to exercise legislative power pose formidable normative challenges for the most celebrated hallmarks of American

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16 See John Rawls, A Theory of Justice 206-207 (revised ed., 1999). According to Rawls’ formulation of the concept of a legal system, coercive rules are addressed to rational persons and define the basic structure within which the pursuit of all other activities takes place must be public. Id. at 207. Echoing this notion, Lon Fuller stated that “[t]he first desideratum of a system for subjecting human conduct to the governance of rules is an obvious one: there must be rules.” See Lon L. Fuller, The Morality of Law 46 (revised ed., 1964).
constitutional democracy including primarily, the protection of constitutional rights and liberties, the separation of powers, and the majority decisional principles used to determine the legitimacy and validity of legal norms on which the legal system rests.\footnote{The use of legislative threats therefore runs afoul the precepts of justice associated with the rule of law. According to John Rawls, the "precepts [of justice] are those that would be followed by any system of rules which perfectly embodied the idea of a legal system," namely, "a system of public rules addressed to rational persons." See Rawls, supra note 16, at 207 (emphasis added).} These normative concerns render the concept and workings of legislative threats as well as the body of invisible law all the more worthy of rigorous theoretical study.

Against this backdrop, a roadmap of this Article is now in order. Part I reviews the social control schemes the legal system \textit{formally} relies upon to produce legal norms: (i) state-mandated regulation of conduct; (ii) state-licensed self-regulation of conduct; and (iii) regulation through litigation. For completeness, this overview also considers extra-legal regulatory institutions, namely private ordering of conduct and social norms, which make up the remainder of the social regulatory universe.

Parts II and III, respectively, lay down the empirical and conceptual foundations as well as the analytic underpinnings of the theory (Part II), and the underlying economic machinations of legislative threats (Part III). Specifically, Part II examines ten case studies drawn from diverse areas of social control that demonstrate the ubiquitous use of legislative threats and elucidate their regulatory function. Abstracting from these context-specific cases, the discussion develops an analytic taxonomy of threats that includes \textit{explicit}, \textit{implicit} and \textit{anticipatory} legislative threats. This taxonomy is valuable not only because it enhances the analytic precision of the inquiry into these threats but, more practically, because it delineates the actual boundaries of the legislative threat phenomenon. The taxonomy also helps to identify instances that would otherwise not be considered as legislative threats, thus exposing the actual scope of this phenomenon. Discovering the broad scope of legislative threats is essential to evaluating their use on normative grounds. Lastly, the taxonomy also generates insights that are necessary to explain the intricate mechanism underlying the inducement effect of legislative threats and their capacity to regulate social conduct.

Part III focuses on the question that lies at the heart of the matter: \textit{How and in what circumstances do legislative threats induce a change in the behavior of entities to which the threat is directed?} In other words, when are threat-recipients expected to comply with the legislator’s demands and when is compliance unlikely? In order to begin analyzing these issues, I rely on non-cooperative game theory and model the strategic interaction between legislators and entities as a (finitely-repeated dynamic) game in which legislators issue \textit{probabilistic threats}. This key characteristic feature of legislative threats derives from the fact that executing a threat does not—and, in fact, cannot—ensure the enactment of the threatened legislation. In other words, the legislator cannot guarantee that the threatened consequences will \textit{actually} materialize. Therefore, the threatened legislation is may be \textit{probable} but definitely \textit{not certain}. Having constructed the model, the analysis examines how a firm determines what its best response is, once a legislator has threatened to enact unfavorable legislation. Using game-theoretic analytical
methods, the model is used to predict how legislators and firms are expected to behave, showing in turn the possible existence of two mutually-exclusive predictions: \textit{compliance equilibrium} and \textit{non-compliance equilibrium}. The analysis thus unveils the potential \textit{inducement effect} of legislative threats, which underlies their regulatory function.

Moreover, the analysis shows that the inducement effect of the threat—that is, whether the firm’s best response strategy is “comply” or “not comply”—crucially depends on what the firm believes the legislator will do in the particular situation; and further, on what the firm believes the likelihood of the threatened legislation is if the legislator carries out the threat. Stated differently, precisely which equilibrium materializes in reality crucially depends on two conditions: (i) whether or not threat-recipients believe that the threat is credible or, rather, “cheap talk” (i.e., the credibility condition); and (ii) whether or not the perceived probability that the threatened legislation will be successfully enacted into law is sufficiently high so as to exceed a given probability threshold below which threat-recipients will not comply, even though the threat is or merely believed to be credible (i.e., the effectiveness condition).

Given that credibility is a necessary (albeit insufficient) condition for inducing a firm’s compliance, the analysis identifies the circumstances in which threats are expected to be credible or incredible. In this respect, the discussion focuses on three mechanisms that may render the threat credible: (i) legislators’ pre-game commitment; (ii) legislators’ reputation; and (iii) legislators’ emotional motivations. In consideration of the effectiveness condition, the discussion underscores a variety of institutional, political, and reputational factors that influence legislative behavior in Congress and therefore the probability of the threatened legislation; and identifies various tactics showing how a legislator may affect that probability, so as to secure the threat’s inducement effect, and guarantee early compliance.

The analysis further shows that compliance with legislative threats is, in essence, a form of implicit and informal political transaction, in which the legislator barters the non-use of legislative power with respect to a particular issue in return for the firm’s commitment to change its conduct. Focusing on bargaining in the shadow of the threat as a form of compliance, the discussion spotlights two important effects: (i) legislative threats elicit valuable information and otherwise reduce transaction costs, facilitating in turn efficient regulatory bargaining; (ii) as legislative threats lower transaction costs and decrease contractual incompleteness, bargaining increasingly provide an opportunity to devise functionally-superior measures to address the very problems to which the legislator initially directed the legislative threat.

For the sake of completeness I extend the analysis to consider games with \textit{perfect} and \textit{imperfect} information, where the legislator can decide the level of severity of the threatened legislation (i.e., lenient, moderate, or severe). If enacted, the threatened legislation affects the firm in \textit{direct proportion} to the leniency, moderation, or severity of its terms. That the legislator also decides whether or not to reveal the level of severity further compounds the analysis but renders the model as descriptive as possible of the real legislative landscape.

Moreover, as legislative threats are most often directed towards numerous entities—rather than a single firm—including businesses in a specific industry, participants in a given market, and members of a certain profession, the analysis considers the effects on compliance of strategic interaction within homogenous and
heterogeneous, organized and unorganized groups. The analysis shows that an entity’s compliance or non-compliance decision is driven in part by the compliance, or non-compliance (e.g., free-riding, holdout) of other entities in the group. Moreover, it is shown that compliance may be used strategically as a tool to promote members’ idiosyncratic interests. Hence, while in some circumstances strategic interaction within groups may undermine compliance (e.g., predatory non-compliance), in certain others it may counter-intuitively reinforce compliance (e.g., predatory compliance, raising rivals’ costs, deterring entry). In addition, the discussion develops several related points, showing that: (i) formal and subtle enforcement mechanisms used by groups play a decisive role in ensuring group-wide compliance; (ii) group organization increases the likelihood of group-wide compliance and renders legislative threats generally more useful in regulating social behavior; (iii) the issuance of a legislative threat (and the advent of collective action problems) reinforces the tendency of unorganized groups to organize; (iv) legislators may (and in some cases do) rationally subsidize the cost of organizing; and (v) the tendency towards organization reduces the transaction costs of bargaining, thereby enabling legislators and group representatives to negotiate and design superior regulatory measures. In turn, these effects further reinforce the legislator’s incentive to use threats and the group’s impetus to organize. Lastly, the analysis shows that insofar as legislative threats increase the propensity to organize, their widespread regulatory use (as a form of social governance) may counter social and economic processes that contributed to the gradual weakening and disintegration of organizations.

Having examined the concept, pervasive use, and economic underpinnings of legislative threats, Part IV focuses on differences between formal legislative measures and informal legislative threats, as alternatives means of social control. The analysis highlights functional and institutional considerations pertaining, respectively, to the comparative capacity of legislative threats to effectively control behavior in an increasingly-complex and information-intensive social reality; and to various political, constitutional, and democratic implications arising from the use of legislative threats. Highlighting these considerations not only advances the understanding of the phenomenon, but is also essential to evaluating on normative grounds the ubiquitous use of legislative threats and to assessing their social welfare implications against explicit normative criteria.

More specifically, functional considerations include: (i) the asymmetric information of social planners and its effects on social control; (ii) the superiority of threat-induced self-regulation of conduct compared with “top down” regulation of conduct; (iii) the capacity of threat-induced self-regulation to accommodate rapidly-changing demands of social control; and (iv) the effects of threat-induced self-regulation on reducing the costs of law enforcement. In this respect, the analysis advances the following claim: legislative threats can be viewed as a spontaneous response (in the sense of unplanned and unregulated) to the institutionally-handicapped position of lawmakers and to the limits of the law in effectively controlling social activities; to that end, legislative threats
are designed to reduce information and transaction costs of policy-making and regulatory bargaining.\textsuperscript{18}

Moreover, institutional considerations encompass ways in which the use of legislative threats enables legislators and regulators to evade procedural safeguards, institutional constraints, and substantive controls designed to limit the power to make law and effect policy changes. These considerations are based upon the following observations: (i) using legislative threats, legislators opt-out of the “rules of the game,” disenfranchise fellow legislators, and are therefore able to effect policy changes notwithstanding a possible lack of majoritarian support; (ii) legislative threats disenfranchise the executive branch by preventing a possible presidential veto and by sidestepping the government’s role in law enforcement; (iii) legislative threats disenfranchise the states by redrawing the federal-state allocation of regulatory powers; (iv) legislative threats bypass constitutional safeguards by evading judicial review of statutes; and (v) legislative threats disenfranchise the judiciary by circumventing precedent-setting interpretation of statutes.

Notwithstanding the superior functional capacity of legislative threats to control behavior in an increasingly-complex and information-intensive society, the institutionally-unregulated and politically-unaccountable use of implicit and explicit threats poses formidable normative challenges for the most treasured attributes of American constitutional democracy. Contrasting these considerations underscores the intrinsic tension between their potential welfare gains and the toll on democratic principles. This conflict therefore raises the ultimate normative question, namely—Is the use of legislative threats as regulators of social conduct socially desirable? The analysis in Part V aims to answer precisely this question against explicit normative criteria, namely: democratic legitimacy and social control efficacy. I argue that, on balance, it seems that even though the benefits of legislative threats may exceed their short-term cost (thus becoming efficient in the short-term), in the long-term the reverse is true, thus suggesting that the best domain of legislative threats consists, in fact, of an empty set. For, any increase in individual well-being and aggregate social welfare—due to the improved efficacy of social control—is inevitably outweighed by a higher commensurate decrease in well-being and social welfare, reflecting in turn the toll of violating constitutional and democratic principles; the negative impact on societal stability and the disincentive on private investment; and the consequential decline in economic growth. In turn, the discussion develops a social control scheme that is rooted in the province of legislation and is designed to ensure the socially-optimal trade-off between regulatory efficacy and the toll on democratic accountability, namely: an outcome-oriented or risk-focused, deferred-implementation, contingent sunset legislation.

I devote the Conclusion to argue that the exponential increase in the complexity of activities and the rapid changes in behavior across all social domains are two major sources of growth-driven social instability. Paradoxically, absent effective social

\textsuperscript{18} The magnitude of transaction costs of policy-making can explain the institutional structure of democratic institutions. See Thrainn Eggertsson, Economic Behavior and Institutions 353-58 (1990).
control, the processes that drive well-developed market economies towards economic growth and social progress, may ultimately propel their economic decline, increase social instability, and lead to their gradual societal deterioration. Thus, the more advanced a society becomes the more demanding is the lawmakers’ role. Viewed from this perspective, the emergence of legislative threats—though institutionally-illegitimate and socially-unwarranted—demonstrates the limits of law and the severe limitations of lawmakers. Moreover, they underscore the growing incapacity of the legal system to deliver its pre- eminent promise: to maintain ordered liberty and to promote sound public policies. Viewed from an ever broader perspective, the widespread use of legislative threats demonstrates an increasing tendency towards (what I label) a second-order social control system, where legislators establish second-order rules designed to create the incentives necessary to induce entities and groups to adopt socially-desired rules of conduct. Inevitably, the trend toward second-order social control diminishes the traditionally-extensive role of the regulatory state, but increases the power of groups that, in shaping their regulatory environment, practically turn into islands of self-regulation.

Lastly, the theory of legislative threats relates to various aspects of policy-making through legislative and administrative rule-making processes, and thus sheds light on the role and function of the law and lawmakers as a form of governance in controlling social conduct and in facilitating economic growth. In this respect, the theoretical analysis relates to the institutional allocation of lawmaking responsibilities, the separation of powers, and the emergence of invisible law. The discussion is expected to draw the interest of a broad audience insofar as it advances existing knowledge and contributes to the literature in a number of fields, including constitutional theory and separation of powers; institutions of economic governance, including law and social control, social norms, private ordering, and self-regulation; the theory of public choice; political economy and political institutional economics; and political science and congressional studies.

I. BACKGROUND: CONVENTIONAL WISDOM ON THE REGULATION OF SOCIAL CONDUCT

According to conventional wisdom, the legal system employs a coercive set of norms to define the basic societal structure within which the pursuit of all activities and conducts may take place. While the work of legislators in Congress and State legislatures account for a significant part of the lawmaking universe, many norms pour forth from various public and private rule-making on both the federal and state levels. The

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19 The coercive power of government to enforce the law is necessary to maintain steady social cooperation and to prevent individuals and firms from sinking into the tragedy of the commons that accompanies institutional break-up. This proposition and its underlying reasoning, of which we think as the Hobbes’s thesis, posit that the existence of effective law enforcement machinery serves as security between individuals. See Howard Warrender, The Political Philosophy of Hobbes, Ch. III (1957) and David P. Gauthier, The Logic of Leviathan: The Moral and Political Theory of Thomas Hobbes 76 89 (1969).

20 See Farnsworth, supra note 2, at 61 (discussing the hierarchy of legislative bodies).
A Theory of Legislative Threats

system relies upon norms of different hierarchies, including statutes, regulations, and opinions, and norms of different kinds, including standards and rules.

Operating in tandem, the lawmaking and law-enforcement functions of the system control the conduct of individuals, firms, organizations, and governmental bodies. Relying on social control as its functional hallmark, the system aims to provide the framework necessary to maintain the stability of social cooperation, to facilitate market exchange and, ultimately, to achieve an efficient allocation of scarce resources. Economic research on the role of legal systems in facilitating markets confirms these arguments. Focusing, for instance, on the effects of legal norms and law enforcement on the depth, breadth, and resiliency of financial markets, empirical research finds that, consistent with the Coasean view, financial markets are more developed in the presence of a well-developed legal system that affords effective investor protection.

From an institutional perspective, the legal system relies upon three norm-producing sources: (i) state-mandated regulation of conduct (i.e., laws, acts, opinions), (ii) rules and standards, and (iii) social norms.

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21 Analytically, opinions (i.e., particularized norms) should be included in the taxonomy of legal norms although they originate from a lawmaking process different than that from which statutes emanate.

22 Rules and standards differ in scope (i.e., the breadth of their potential application); the level of generality or particularity; the amount of information necessary to enforce them; the scope of discretion they entail; and in the degree of uncertainty (i.e., the level of variability in outcomes), thereby serving different social control functions. See Louis Kaplow, Rules Versus Standards, 42 DUKE L.J. 557 (1992). Legal norms employ exceptions, presumptions, and other means to manage the tension between generality and particularity. See Frederick Schauer, Exceptions, 58 U. CHI. L. REV. 871 (1991) (exceptions link scope of rules to linguistic underpinnings).


24 See Rawls, supra note 16, at 206-207 (the system’s comprehensive scope “reflect the fact that the law defines the basic structure within which the pursuit of all other activities takes place”).

25 Legal norms not just facilitate market exchange but also “commoditize” specific goods so as to create a market for such goods. Assuming the market is not prone to systemic failures, this would result in an efficient distribution of the “commodity” in question.

26 The indispensable role of a well-developed legal system in reducing transaction costs to facilitate market exchange has been identified by Ronald H. Coase in The Problem of Social Cost, 3 J. L. & ECON. 1 (1960) and The Firm, the Market, and the Law, in THE FIRM, THE MARKET, AND THE LAW 1, 9 (1988) (“for anything approaching perfect competition to exist, an intricate system of rules and regulations would normally be needed”). See also Ronald H. Coase, The Institutional Structure of Production, in ESSAYS ON ECONOMICS AND ECONOMISTS 3, 11-12 (1994) (“If we move from a regime of zero transaction costs to one of positive transaction costs, what becomes immediately clear is the crucial importance of the legal system in this new world”).

27 See Paul H. Rubin, Legal Systems as Frameworks for Market Exchanges, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS (Claude Manard & Mary Shirley eds., 2004) (countries with a well-established legal system that defines property rights, allows for their exchange, and protects property rights are more prosperous and exhibit higher growth rate than countries lacking such a system).


29 Broadly defined, however, norms are not limited to these three sources; private ordering and social norms...
regulations, and ordinances made by primary and secondary legislative bodies); (ii) state-licensed self-regulation of conduct (i.e., rules and regulations adopted by self-regulatory organizations pursuant to statutory authorization); and (iii) regulation through litigation (i.e., judge-made laws declared in court opinions and regulatory policies crafted in negotiated resolutions of large-scale litigation). Virtually all legal norms (as distinguished from social norms and private ordering that are discussed below in Parts I(D) and I(E), respectively) originate from one of these sources.

Human behavior is influenced both by internal norms and values as well as by exogenous restrictions such as legal sanctions. The order we see around us is only partially explained by the existence of law and law enforcement. Thus, notwithstanding their broad scope and general applicability, legal rules account only for a fraction of the social control universe. Extra-legal rules, including those originating from the private ordering of conduct as well as various types of social norms, make up the remainder. Similar to legal norms, the extra-legal regulation of conduct emanates from a specified rule-making process that may have formal or informal attributes. Furthermore, depending on the specific context to which legal norms apply and the ability of regulated entities to opt-out, the function served by private ordering and social norms in controlling behavior may substitute or complement that of the legal system.

The comparative institutional analysis that follows presents an overview of legal and extra-legal regulatory schemes. In the interest of clarity, the analysis considers (i) the rule-making process from which norms originate; (ii) the regulatory domain; (iii) the constraints limiting the rule-making power; and (iv) the range of enforcement mechanisms used to ensure compliance. Laying down these intellectual foundations serves at least three purposes. First, understanding conventional schemes of social control is conducive to advancing the concept of legislative threats and to appreciating its novelty. Second, familiarity with these schemes is essential to examining the comparative functional effects, costs, and benefits of legislative threats and alternative regulatory schemes. Third, gaining knowledge of these issues is necessary to assessing the normative desirability of using threats to further predetermined social objectives.

A. State-mandated Regulation of Conduct

Conceptually, state-mandated regulation of conduct encompasses all legal norms formally enacted by the polity and its administrative organs, including statutes,

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30 Cf. Oliver Williamson, Credible Commitments: Using a Hostage to Support Exchange, 73 AM. ECON. REV. 519 (1983). Williamson coins the idea of legal centralism to express the notion that the existing social order results from the law and its enforcement. Nowadays, however, a plethora of theoretical and empirical literature challenges this proposition. See generally Robert Axelrod, The Evolution of Cooperation (1984); see also Robert Sugden, Spontaneous Order, 3 J. ECON. PERS. 85 (1989) (conditions under which conventions are established).


32 However, my analysis does not address theoretical issues relating to the coordination, prioritization, and integration of norms originating from different sources.
regulations, ordinances, and orders. These norms are mandated insofar as they are created and imposed by the state. As I demonstrate below, “top down” law differs from “bottom up” norms (i.e., self-regulation of conduct, private ordering, and social norms). Subject to procedural and substantive constraints, the regulatory scope of formal legal rules encompasses all aspects of modern social, political, and economic life, ranging from the control of individual conduct to the regulation of business organizations, markets, government agencies, and the judiciary. Indeed, these legal norms make up a voluminous body of law and, as such, represent the regulatory scheme most heavily relied upon to control behavior across a wide variety of contexts.

The Securities Exchange Act of 1934 and the rules and regulations adopted by the Securities and Exchange Commission (SEC) pursuant to statutory authority, demonstrate the use of this scheme to control the conduct of issuers, insiders, underwriters, and other financial markets participants. However, the regulatory framework governing U.S. financial markets is more complex than suggested above, as it includes rules adopted by self-regulatory organizations (e.g., the New York Stock Exchange) pursuant to a state-granted rule-making license and rules made up by courts and promulgated in judicial opinions. Lastly, informal social norms and private ordering supplement the legal norms and contribute to shaping the ultimate regulatory environment governing financial markets.

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33 Under the Constitution, the President has limited power to issue Executive Orders, which are also considered legislative in nature and analytically belong to this category of regulatory measures.

34 Documenting the increasing quantity and importance of statutes and regulations as a means of controlling social conduct, Felix Frankfurter observed in 1947 that “[j]nevitably the work of the Supreme Court reflects the great shift in the center of gravity of lawmaking. Broadly speaking, the number of cases disposed of by opinions has not changed from term to term. But even as late as 1875 more than 40% of the controversies before the Court were common-law litigation, fifty years later only 5%, while today cases not resting on statutes are reduced almost to zero. It is therefore accurate to say that courts have ceased to be the primary makers of law.” See Felix Frankfurter, Some Reflections on the Reading of Statutes, 47 COLUM. L. REV. 527 (1947).


36 See Rafael La Porta et al., Law and Finance, 106 J. POL. ECON. 1113 (1998) (showing that concentrated ownership of shares in public companies is negatively related to the legal protection of investors, which is consistent with the hypothesis that investor protection laws aid in the development of capital markets).


40 Corporate law and social norms interact with each other, such that the impact of social norms is greatest when the law is weakest. See, e.g., John C. Coffee, Do Norms Matter?: A Cross-Country Examination of the Private Benefits of Control, COLUM. L. & ECON. WORKING PAPER NO. 183 (2001), at http://www.ssrn.com (social norms
State-mandated legal norms originate from deliberative rule-making processes of primary and secondary legislative bodies. Ordinarily, these rule-making processes are transparent to the public eye, well-structured, and governed by a set of legal rules that prescribe how valid rules are to be made. Functionally, these procedures are designed to ensure that the rule-making adheres to legitimate decisional rules; provides sufficient opportunity to gather information (e.g., through public comments); and enables meaningful deliberation and consideration (e.g., through floor debate and hearings).

The power to craft legal norms to control social behavior is however, clearly limited. Substantive and procedural constraints erect significant limitations to the rule-making power, thus aiming to safeguard constitutional rights and liberties; prohibit the retroactive application of legal norms; guarantee reasonable determinacy of legal norms; ensure that legal norms do not single out an individual or a particular group; and limit or invalidate a broad delegation of legislative powers to inferior bodies.

Lastly, the legal system relies upon various enforcement mechanisms to ensure compliance with legal rules. While some are designed to work ex ante, before a violation has occurred, others operate ex post, in response to a violation or infliction of harm. Furthermore, while in some contexts law enforcement is initiated by public officials (e.g., attorney general actions, parens patriae actions, and criminal prosecution), enforcement actions may also be commenced by private entities (e.g., class actions, qui tam actions, and private prosecution of offenses). Lastly, the particular composition of enforcement mechanisms may vary from one legal context to another.

may discourage predatory behavior by those in control of the firm but their impact is negatively-correlated with the impact of legal rules). See also Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 U.C.L.A. L. Rev. 1009 (1997) (Delaware cases best understood as attempts to create social norms).

42 See U.S. CONST., art. I, § 9 (“No … ex post facto Law will be passed”).

43 The void-for-vagueness doctrine is designed to ensure that legal norms are not excessively vague and not unreasonably uncertain, as in such cases the person to whom it is addressed may not know what the norm requires. See, e.g., Jeremy Waldron, Symposium: Void for Vagueness—Vagueness in Law and Language: Some Philosophical Issues, 82 CALIF. L. Rev. 509, 536 (1994) (vague provisions are unfair because, when law is enforced, a citizen becomes a victim of retroactive legislation). Vague rules encroach on protected constitutional rights and limit the individuals’ realm of personal or economic freedom. See Friedrich A. Hayek, The Constitution of Liberty 152-53 (1960). A law-and-economic expression of this intuition is found in Richard Craswell & John E. Calfee, Deterrence and Uncertain Legal Standards, 2 J.L. ECON. & ORG. 279, 281 (1986) (uncertain about a legal standard, an individual tends to over-comply because knowing that there is a risk that he will be held liable even when he complies, the decrease in the risk of liability gained by over-compliance may offset its cost).

44 A legal norm must be of general applicability, meaning that a norm cannot single-out an individual or group of individuals. See U.S. CONST., art. I, § 9. The rationale underlying the Bill of Attainder Clause is the implementation of the separation of powers as a general safeguard against legislative exercise of the judicial function or, more simply, trial by legislature. See U.S. v. Brown, 381 U.S. 437, 440 (1965).


B. State-licensed Self-regulation of Conduct

State-licensed self-regulation of conduct represents a regulatory regime in which private entities including, among others, industrial sectors, trade and professional organizations, and national securities or commodities exchanges formulate and adopt legal rules pursuant to a statutory delegation of rule-making power. Highlighting the virtues of self-regulation, economists maintain that this scheme enables entities that possess most information or are otherwise better-positioned to diagnose problems and devise efficient regulatory measures, to establish effective compliance architectures. Moreover, in certain contexts self-regulatory organizations (SROs) are bound to have stronger incentives than other lawmakers to design desirable regulatory measures. In addition, self-regulation offers a superior cost-effective institutional alternative.

Seeking to secure the efficiency gains associated with self-regulation, legislatures ordinarily enact a statute to lay down the relevant regulatory objectives and entrust the task of devising, tailoring (and also enforcing) detailed rules to a rule-making body that represents the entities engaged in that economic sector or activity. Yet, the statutory license normally also limits the regulatory mandate, both procedurally and substantively. Compliance with these procedural requirements and substantive constraints is a sin qua non of a legally-effective rule.

The underlying rationale is that while self-regulation can enhance social welfare, it is also prone to unconstrained self-interest and self-dealing opportunism, and other forms of rent-seeking. Thus, absent limitations on the rule-making mandate, there are
no guarantees that SROs will adequately account for negative externalities. Concretely, such rules may protect incumbents in the industry and entrench their market position, erect inefficient barriers to entry and inhibit market competition, erode the quality of services and products offered to consumers, and shield firms from liability. All of these work to the detriment of consumers and other third-parties.

The sharing of regulatory responsibility with SROs has a lengthy historical precedent and in recent years, has been expanding both domestically and abroad. Nowhere is the expansion of the self-regulation as prevalent as in the commercial, financial, and business sectors. The most recent addition to the pool of SROs is the Public Company Accounting Oversight Board (PCAOB), a nonprofit company that was established by Congress in 2002 as a response to governance crises in American public corporations. The Sarbanes-Oxley Act entrusts the PCAOB with the task of overseeing the audit of public companies in order to protect investors. To that end, “[t]he Board shall establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers.”

Similarly, national securities exchanges that operate under the federal securities laws and register with the SEC as such, are required to adopt rules that govern the conduct of their members, including issuers, dealers, trading specialists, and other financial market participants. Exercising its rule-making power, the New York Stock Exchange (NYSE) has adopted a highly-detailed set of rules designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of securities trading, and provide a means by which the NYSE can take appropriate

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54 See Bernard S. Black, *The Role of Self-Regulation in Supporting Korea’s Securities Markets*, 3 J. KOREAN LAW 17 (2003) (in order to successfully compete for trading in shares of cross-listed Korean companies, Korea will need both legislative change and stronger self-regulation of listed companies).


57 See Sarbanes-Oxley Act § 101(a).

58 See Sarbanes-Oxley Act § 101(c)(2). As with other SROs, the Act delegates enforcement responsibility to the PCAOB. Specifically, the PCAOB registers public accounting firms (§ 101(c)(1)); conducts inspections of registered public accounting firms (§ 101(c)(3)); conducts investigations and disciplinary proceedings (§ 101(c)(4)); and enforces compliance with the Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports (§ 101(c)(6)).


60 NYSE rules seek to prevent misappropriation of customer funds and excessive or unauthorized trading in customer accounts. See New York Stock Exchange Rule 408.

61 For example, all NYSE member firms are subject to the “know your customer” rule, which requires firms to obtain essential facts about the customer that are important for the customer’s investment decisions. See New York Stock Exchange Rule 405.
disciplinary actions against its membership.\textsuperscript{62} NYSE self-regulation is subject to the SEC, which reviews proposed rules, their intended purpose, and their statutory basis.\textsuperscript{63}

The National Association of Securities Dealers (NASD), the trade organization of the securities industry, has also been granted the mandate to regulate the conduct of its members. As the world’s largest private-sector regulator of financial services, NASD Regulation, Inc. touches upon virtually every aspect of the securities industry. By law, every securities firm doing business with the American public must register with NASD.\textsuperscript{64} Today, about 5,400 brokerage firms and more than 665,000 stockbrokers and registered representatives fall under NASD’s regulatory jurisdiction. NASD’s self-regulation encompasses a wide array of issues, including the registration and conduct of securities firms and the maintenance of the high-quality service of its members.\textsuperscript{65}

Lastly, SRO-adopted rules must also be enforced in order to ensure adequate compliance incentives and achieve the underlying statutory objectives.\textsuperscript{66} Lenient or inadequate enforcement, however, will result in suboptimal compliance and—assuming SROs on average adopt efficient rules—in some loss of social welfare.\textsuperscript{67} As with the adoption of rules, this concern arises because SRO enforcement is prone to self-interest and self-dealing, opportunism, and other forms of abuse. Suboptimal enforcement can wear away the institutional advantages of SROs as a social control mechanism and diminish the corresponding welfare gain. SROs’ enforcement policies are subject to government oversight and to the threat of intervention, often resulting in higher enforcement activity: just enough to preempt intervention.\textsuperscript{68}

\section*{C. Regulation through Litigation}

Regulation through litigation encompasses judge-made law declared in court opinions and regulatory policies crafted in negotiated resolutions of large-scale litigation. The latter has emerged in recent years as a new vehicle for regulating

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\item \textsuperscript{62} The Exchange maintains a self-regulatory system, acting as the SEC-appointed Designated Examining Authority with respect to member firms. \textit{See NYSE Regulation}, at http://www.nyse.com/regulationl (last visited Dec. 16, 2005).
\item \textsuperscript{63} The Municipal Securities Rulemaking Board (MSRB), a self-regulatory organization established by Congress in 1975, and supervised by the SEC, is the primary regulatory authority in the municipal securities market. \textit{See 15 U.S.C.S. § 78o-4(b)}. The MSRB can propose and adopt rules to effectuate the purposes of the Securities Exchange Act of 1934 with respect to transactions in municipal securities. \textit{See Grandon v. Merrill Lynch & Co.}, 147 F.3d 184, 190 (2d Cir. 1998).
\item \textsuperscript{64} For detailed information about NASD’s regulatory and compliance architecture see \textit{NASD Rules & Regulations}, at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=6 (Dec. 16, 2005).
\item \textsuperscript{65} When necessary, NASD can bring enforcement actions against those who violate the rules. These actions are handled by NASD enforcement mechanisms.
\item \textsuperscript{66} In order to ensure compliance, the NASD takes enforcement actions that include expelling and suspension of member firms. \textit{See NASD Five-Year Statistical Review 2002–2006}, at http://www.nasd.com (Dec. 19, 2005).
\item \textsuperscript{67} I assume that enforcement mechanisms used by SROs operate efficiently in that the social cost of enforcement is lower than the social benefits gained from compliance. Given this assumption, lenient or inadequate enforcement will necessarily result in social loss.
\item \textsuperscript{68} \textit{See Peter M. Demarzo et al., Self-Regulation and Government Oversight}, 72 \textit{REV. ECON. STUD.} 687 (2005) (assuming SROs seek to maximize their members’ welfare, SROs will choose a more lax enforcement policy than what is necessary to protect customers unless the government monitors self-regulation and enforcement).
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conduct, thus blurring the institutional allocation of regulatory and adjudicatory responsibilities between legislators and courts, respectively. 69 Mega-lawsuits involving asbestos risks, 70 tobacco and gun injuries, 71 breast implant defects, 72 lead paint hazards, 73 and other harmful products resulted in negotiated policies designed to settle these lawsuits. In some instances, the vast liability exposure of industrial defendants worked as a financial lever to impose a policy change on entire industrial sectors. 74 To date, the Master Settlement Agreement that was negotiated with the tobacco industry provides the most noteworthy example of regulation through litigation. 75

Regulatory policies negotiated in settlement usurp traditional legislative and administrative rule-making mandates, as they do not emanate from a publicly-visible, legislative rule-making process. Having been identified as a new form of social engineering, such cases shifted the locus of policy-making to courtrooms, so as to empower federal and state judges. 76 In this respect, Alabama Attorney General

69 See generally W. Kip Viscusi, Overview, in W. Kip Viscusi (ed.), Regulation Through Litigation 1-20 (2002). The interaction between litigation and regulation emerges because many of the economic rationales underlying regulation, including forms of market failures (e.g., negative externalities to people not parties to a market exchange, asymmetric consumer information) also give rise to the mega-lawsuits discussed below.

70 Historically, exposure to asbestos risks has not been subject to stringent regulation. Yet, the wave of asbestos-related litigation has induced the Occupational Safety and Health Administration (OSHA) and the Environmental Protection Agency (EPA) to introduce a strict regulatory framework, thus creating strong incentives to reduce asbestos-related risks and injuries.

71 The gun litigation involved lawsuits brought by local governments against the firearms industry, seeking to hold it liable for the cost associated with gun violence. Inspired by the tobacco cases, the litigation was initiated by New Orleans and Chicago and followed by thirty other cities. See David Kairys, The Cities Take the Initiative: Public Nuisance Lawsuits against Handgun Manufacturers, in GUNS, CRIME, AND PUNISHMENT IN AMERICA 363-83 (Bernard E. Harcourt ed., 2003). The settlement introduced regulatory measures, including changes in safety devices and distribution of firearms. See Phillip J. Cook & Jens Ludwig, Litigation as Regulation: Firearms, in Viscusi, supra note 69, at 67-93 (analyzing the settlement’s regulatory impact).

72 The litigation resulted in a multibillion dollar class settlement, providing compensation for injuries and thereby forcing manufacturers out of the market. While the settlement did not introduce regulatory measures, it played an important role in generating risk-related information and, consequently, leading the FDA to ban implants. See Joni Hersch, Breast Implants: Regulation, Litigation, and Science, in Viscusi, supra note 69, at 142-43.

73 See Randall Lutter & Elizabeth Mader, Litigating Lead-Based Paint Hazards, in Viscusi, supra note 69, at 105-135 (the lead paint wave of litigation, including lawsuits of state and local governments against paint manufacturers and lawsuits of tenants against landlords, was a poor institutional solution to address social problems associated with lead exposure).

74 Cf. Rubenstein, supra note 9 (the settlement of large class action lawsuits are essentially significant commercial transactions in which defendants purchase finality).

75 This settlement led to the imposition of charges on future consumers on a per unit basis and thus ended lawsuits brought by state governments to recover Medicaid expenses that they had attributed to tobacco consumption. The charges imposed (essentially, an excise tax), were expected to award plaintiffs (i.e., forty-six states, the District of Columbia, and five U.S. territories) $229 billion over a period of twenty-six years, from 1999 to 2025. The settlement also introduced regulatory restrictions concerning tobacco advertising (which, arguably, had anticompetitive effects). See David M. Cutler et al., The Economic Impacts of the Tobacco Settlement, 21 J. POLICY ANAL. & MANAG. 1 (2002) (examining the impact of the settlement on health costs).

76 Judge Weinstein of the Federal District Court for the Eastern District of New York observes that in mass tort cases (including the Agent Orange case over which he presided) “judges have found themselves involved in settlement discussions in a manner that would be unusual in an ordinary tort case or a commercial dispute.” See Jack Weinstein, Individual Justice in Mass Tort Litigation 102-3 (1995).
pointedly observed that “[t]he aim of this litigation [was] to shift the awesome powers of the legislative bodies—powers to control commercial regulation, taxation, and appropriation—to the judicial branch of government. With that shift comes an assault on civil rights, democratic representation, and free enterprise.”

Compared with state-mandated regulation or even self-regulation, regulatory measures crafted through settlements of large-scale litigation involve very limited public input or expertise. Even worse, these policies are subject to virtually no institutional accountability. Not surprisingly, this phenomenon has been subject to harsh criticism on the grounds that devising regulatory policies through litigation disenfranchises constituencies and is therefore anti-democratic. This result is by and large inevitable, owing to the institutional constraints within which courts operate. Courts (and this is no secret) are not capable, let alone well-positioned to take into account macro-level and diverse societal considerations that ought to shape the regulatory choice. They lack the tools necessary to evaluate the impact and desirability of a given regulatory policy.

Similar limitations, not to mention rational self-interest, confine or even inherently bias the capacity of the parties to craft effective, socially-balanced regulatory policies. For, as publicly-minded as plaintiffs’ attorneys may be, they cannot—nor do they have the incentives to—adequately represent the social interests in question. It therefore

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77 See State Attorney Generals and the Power to Change the Law, in REGULATION BY LITIGATION: THE NEW WAVE OF GOVERNMENT-SPONSORED LITIGATION 1, 3-6 (Manhattan Institute, 1999) (suits against the tobacco and firearms industries trample upon the separation of powers as a defining feature of the rule of law).


79 James Wootton, President of the Institute of Legal Reform at the U.S. Chamber of Commerce, observed that “[w]hen issues of great importance are settled by undemocratic means, people feel that they have been shut out of the decision-making process.” See Litigation or Government Regulation, in REGULATION THROUGH LITIGATION: ASSESSING THE ROLE OF BOUNTY HUNTERS AND BUREAUCRATS IN THE AMERICAN REGULATORY REGIME 1, 2 (1999) (hereinafter: “Litigation or Government Regulation”).

80 For a discussion of the institutional constraints within which courts operate, see Lon L. Fuller, The Forms and Limits of Adjudication, 92 HARV. L. REV. 353 (1978).

81 Commentators observe that, as a general matter, “legislatures have the comparative advantage over courts in acquiring, evaluating, and acting upon the relevant expert information and knowledge needed for rationally and reliably determining the appropriate standard of optimal precautions and the mode of enforcing the standard. ... The questions implicated by those judgments ... span multiple, diverse disciplines, including science, technology, business organization and finance, economics, and distributive and other public policies.” See Charles Fried & David Rosenberg, Making Tort Law: What Should Be Done and Who Should Do It 94 (2003).

82 Arguably, government regulation is appropriate when policy decisions apply to an entire product line or market. Design defects and safety issues should be assessed and set on a product-wide basis. See W. Kip Viscusi, Overview, in Viscusi, supra note 69, at 1-2.

83 Surely, plaintiffs’ attorneys (hired by the government to handle mega-lawsuits) and, more so, corporate defendants not only tailor settlement terms to promote self-interests, but also consider short time-horizons and less information than is necessary to design socially-desirable regulatory measures.

84 See Litigation or Government Regulation, supra note 79, at 1-2 (discussing conflicts of interest affecting the conduct of private attorneys who lead these cases).
stands to reason that regulatory measures crafted and shaped by repeat corporate
defendants in order to settle mega-lawsuits will pass judicial muster despite their
inherent self-serving features. Thus, regulation through litigation can be viewed as an
especially troubling version of regulatory capture, wherein “regulators” are briddled by
and serve the interests of those whose conduct they are expected to regulate.
Lastly, these institutional shortcomings worsen when decisions that shape the
“regulatory” end-product are delegated to juries on a case-by-case basis. Juries, as we
know, are ill-equipped to systematically analyze risk, information, and other matters
that arise in such cases and ultimately bear on the negotiated policy. Behavioral-
economic research demonstrates the cognitive failings and mental heuristics to which
jurors are prone, including hindsight, anchoring, availability, and framing biases.
Given these institutional hindrances, regulation through litigation is destined to
prescribe socially-inefficient regulatory measures.

D. Private Ordering as a Regulator of Conduct

Private ordering operates as a regulator of conduct in certain social contexts. For
instance, the case of eBay, which hosts the world’s largest online trading community,
provides a fascinating example of the role and functioning of private ordering in
regulating a community and the behavior of its members. Members buy and sell in

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85 Documenting the institutional shift from litigation to regulation, economists Edward Glaeser and Andrei
Shleifer observed that during the Progressive Era, the U.S. replaced litigation by regulation as the principal
mechanism for the social control of business. Explaining this shift, they suggest that courts are more
vulnerable to subversion than regulators, especially given the significant inequality in distribution of wealth
and political power in society. See Edward L. Glaeser & Andrei Shleifer, The Rise of the Regulatory State,

Capture (1988) (explaining regulatory capture). Empirical research shows that regulatory capture is associated
with distorted incentives, social welfare losses, and lower growth rates. See Irina Slinko et al., Laws for Sale: An

87 Kip Viscusi reports a study that demonstrates that jury-eligible citizens do not properly apply negligence
rules. Data gathered in this study shows that jurors are particularly prone to erroneous risk beliefs and are
subject to the zero-risk mentality. See W. Kip Viscusi, Jurors, Judges, and the Mistreatment of Risk by the Courts, 30
J. LEGAL STUD. 107 (2001); see also W. Kip Viscusi, The Challenge of Punitive Damages Mathematics, 30 J. LEGAL
STUD. 313 (2001) (anchoring effects of appeals by plaintiff’s lawyers or media coverage lead jurors to abandon
punitive damages formulas). While a balance of risks and costs lies at the heart of the negligence standard,
jurors penalize corporate defendants in instances in which the company performed risk analyses and decided
gainst making a safety improvement after the analysis indicated that the improvement was unwarranted. See W. Kip Viscusi,

88 To clarify, I do not claim that the legislative or administrative processes are free of errors or other
shortcomings. See, e.g., W. Kip Viscusi & James T. Hamilton, Are Risk Regulators Rational? Evidence from
Hazardous Waste Cleanup Decisions, 89 AM. ECON. REV. 1010 (1999) (target risk levels chosen by regulators with
respect to the cleanup of hazardous waste sites are inefficient, as they are largely a function of political
variables and risk perception biases, including the anchoring and the availability heuristics).

89 Research in this area focuses on the “potential enforcement mechanisms [that are] available to support
agreements” without reliance on legal norms. See Gillian K. Hadfield, Contract Law is Not Enough: The Many
Legal Institutions that Support Contractual Commitments, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS
(Claude Manard & Mary Shirley eds., 2004); see also See John McMillan & Christopher Woodruff, Private Order
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auctions conducted on the eBay website. Over the last decade the community has grown exponentially, reaching as many as 150 million registered members worldwide who are set to buy and sell goods worth more than $40 billion. As The Economist observed, “from being a website begun as a hobby and often used to trade collectibles such as Beanie Babies, it has become an economy in its own right.” The success of this marketplace depends on the ability of buyers and sellers to feel secure in conducting transactions. Ensuring fair dealing, deterring fraud, and providing mechanisms to enforce online transactions are therefore essential to this community. Even though activity conducted on eBay’s trading platform is subject to state law, eBay has supplemented the law with its own policies and rules, all of which are designed to maintain a secure online environment. To that end, “eBay’s reputation-management [and dispute resolution system] establishes a level of order and trust.”

The regulatory use of private ordering flourishes in many sectors and organizations including the Japanese mafia; in the U.S. cotton industry; and among Jewish Ultra-Orthodox diamond merchants in the New York City. Moreover, the societal interests served by private ordering predate the Internet. It is known, for example, that (similar to Internet-age eBay) pre-legal societies that reigned in the Mediterranean in the Medieval period relied upon private ordering to facilitate

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90 See Anniversary Lessons from eBay, THE ECONOMIST, June 11, 2005 at 11 (discussing the exponential growth of eBay’s trading community and the main features of its trading platform). “The remarkable tale of eBay’s growth points to some important lessons ... To succeed, firms need ... to listen carefully to their customers, paying close attention to what they do and don’t want.” Id.


92 For example, eBay offers a dispute-resolution service and buyers and sellers who violate the trading rules can be expelled. See Meg and the Power of Many, supra note 91, at 63, 64, 66 (discussing rules that govern trading on eBay’s platform and the PayPal money transfer system that reduces the probability of fraud). See also David P. Baron & David Hoyt, eBay: Private Ordering for an Online Community (2001) (same).

93 See Meg and the Power of Many, supra note 91, at 63. When a transaction is completed, buyers and sellers are invited to rate how successful it has been and review the other party. These reviews can be read by all users. Indeed, many users have come to value their reputations because traders earning sufficient positive feedback from parties with whom they have transacted are eligible for refunds.


In sum, private ordering provides an effective self-enforcing regulatory institution where state law is either undeveloped or non-existent; where reliance on state law is not a viable option (due to, for example, regulatory capture and other rent-seeking behaviors that result in inherently-biased legal norms); and, lastly, where enforcement institutions are ineffective (e.g., where the judiciary is prone to political subversion).

**E. Social Norms as Regulators of Conduct**

Extra-legal regulatory measures encompass social norms which, like private ordering, regulate conduct for which a consensus has emerged. Conceptually, a social norm is a rule that is neither formally promulgated, nor enforced by a threat of legal sanctions. Unlike legal rules, norms do not follow from a well-defined, deliberative rule-making process but, rather, result from the gradual, decentralized emergence of a social accord concerning a particular conduct. Repeated behavioral patterns gradually ossify into a custom and subsequently into a norm. This is why norms are accorded presumptive legitimacy and provide an effective control mechanism.

Enforcement of norms relies upon such mechanisms as the inculcation of values and social sanctions. When the underlying values are properly internalized, an individual will experience remorse when in violation of a norm. Both the magnitude of one’s remorse and the incentives to comply are affected by how well (or how poorly) the norm is complied with by others. Social sanctions, on the other hand, include...

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102 Experiments show that cooperation among individuals facing social dilemmas increases if they are allowed to communicate before making a choice because intra-group communication elicits social norms to which the group adheres. See Cristina Bicchieri, *Covenants Without Swords: Group Identity, Norms, and Communication in Social Dilemmas*, 14 RATIONALITY & SOCIETY 192 (2002).


105 See Peter H. Huang & Ho-Mou Wu, *More Order without More Law: A Theory of Social Norms and Organizational Cultures*, 10 J. L. ECON. & ORG. 390 (1994) (subjective expectations concerning the likelihood of violations by others influence one’s decision whether or not to violate the norm because the higher the...
refusals to interact with the offender; denial of social benefits; condemnation of one’s conduct; feelings of shame, guilt, and humiliation; and loss of reputation.\textsuperscript{106}

Lastly, the regulatory domain of social norms comprises a wide variety of activities: etiquette, tipping,\textsuperscript{107} and business practices\textsuperscript{108} are but a few examples.\textsuperscript{109} Many commonplace behaviors are in fact norm- rather than law-driven. Yet, because social norms are basically a public good—as no one can claim credit for creating or enforcing a welfare-enhancing norm—their creation and enforcement will be insufficient given what is optimal for the group as a whole.

\section*{II. The Social Landscape Re-examined: Legislative Threats as Regulators of Social Control}

Though legislative threats function as regulators of conduct, they are anything but standard legal norms; nor do they qualify as extra-legal norms. In fact, in distinct contrast to legal and extra-legal control of social conduct, legislative threats present an innovative, unaccounted for regulatory strategy. As the analysis below shows, legislative threats control social behavior in an entirely different manner than that which underlies formal legal rules. Legislative threats may bear a wielding effect on the conduct of firms and organizations to which the threat is directed, thus inducing these entities to radically alter their behavior so as to bring it in line with the threat.

Notwithstanding their potent regulatory impact, legislative threats neither result from a rule-making process nor are they accompanied by a formal enforcement mechanism. Analytically, legislative threats do not fit within any of the aforementioned regulatory schemes. They are not the end-product of a state-mandated regulation of conduct nor do they qualify as rules adopted pursuant to a state license granted to private lawmakers (firms, trade organizations, professions, etc.) to engage in the self-regulation of conduct. Counter-intuitively, the capacity of legislative threats to control behavior arises from an absence of any rule-making product.\textsuperscript{110}

Against this backdrop, the theory I develop below presents a coherent, analytic account of legislative threats as an innovative regulatory mechanism. Section A examines ten case studies that are drawn from diverse areas of social control and demonstrate the ubiquitous use of legislative threats as regulators of social conduct. Section B subsequently presents an analytic taxonomy of threats that includes explicit, implicit and anticipatory legislative threats. This taxonomy is valuable not merely


\textsuperscript{110} This effect on behavior, to which I refer as the “inducement effect”, is explained in Part III below.
because it enhances the analytic precision of our understanding of these threats but, more practically, because it delineates the actual boundaries of the phenomenon of legislative threats. The taxonomy also helps to identify instances that would otherwise not be recognized as legislative threats, thus bringing to light the actual scope of this phenomenon. Lastly, the taxonomy generates insights that are necessary to explain the intricate mechanism underlying the inducement effect and capacity of legislative threats to regulate social conduct.

A. How Do Legislators Go about Doing their Legislative Business?

We are accustomed to thinking about the role of legislators and the function that the legislative process serves in a rather straightforward fashion, namely—that benevolent legislators propose, craft, and work to enact legislative measures that control social and governmental conduct and enhance social welfare. Further, we ordinarily think that it is precisely to that end that they debate and deliberate, hold committee hearings and plenary sessions, employ staff and aids, negotiate terms with their opponents, draft and redraft proposed bills, and exercise their legislative powers. The legislative process, we tend to presume without a great deal of skepticism, is designed to produce a formal piece of legislation such as the recent Sarbanes-Oxley Act of 2002.

This rather utopian representation of the legislative process fails on two counts, however—(i) the public choice count, and (ii) the instrumental count. First, legislators—and this is not a secret or a surprise—conduct their political business so as to advance their political self-interest and not necessarily the social good. Instead, the regulatory initiatives and decision-making of legislators in many areas of social policy often cater to special interests and, hence, can only be explained by the steadfast pursuit of political and personal gain. Second, even if we assume goodwill on the part of...
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legislators, it still does not follow as a matter of strict logic that legislators will necessarily rely upon legislative measures as the instrument of choice to control conduct and maintain social order. Rather, even benevolent legislators may—and in many instances do—use legislative threats rather than legislative measures to induce regulatory changes that promote the social good.

I argue that the inner workings of legislators on Capitol Hill, at the House of Parliament, or at the Bundestag are far more intricate than what is ordinarily thought or commonly observed. Counter-intuitively, the day-to-day legislative business and the use of the legislative process more generally are often strategically designed to serve a contrary objective. That is, to avoid enacting a new legislative measure altogether. The legislative process is frequently used solely to exert threats of impending legislation rather than to enact any legislative measure. Therefore, the formal and observable body of legislative measures is nothing but the tip of the “regulatory” iceberg. It certainly does not account for the full picture, which must also encompass legislative threats and the ensuing body of invisible law (i.e., informal regulation of social conduct).

The prevalent use of legislative threats incorporates all areas of activity, ranging from cyber-security and e-piracy to digital obscenity and air-pollution; from hazardous waste recycling to greenhouse gas emissions; from D&O compensation and money laundering to fighting obesity and the use of illegal substances. Notably, legislative threats provide an effective regulatory strategy to control the behavior of firms, organizations, professions, industrial sectors, and governmental agencies. In certain cases, legislative threats have even been used by the federal government and federal...
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legislators to regulate the conduct of U.S. states.\footnote{119 In a recent paper, Mark Roe re-conceptualized the race-to-the-top theory of state competition in corporate law. Roe argues that Delaware's competitive pressure comes not from other states but from the federal government. He posit that when the issue is important, the federal government either takes over the issue or threatens to do so, thereby making Delaware legislators conscious that if they misstep, federal authorities could step in. The threat that important issues will be taken away if Delaware players damaged the economy or riled powerful interests has conditioned Delaware's behavior in shaping its corporate law. The Sarbanes-Oxley Act of 2002, enacted following the corporate governance failures in Enron and WorldCom, demonstrates, in Roe's opinion, how Congress took over corporate law issues. \textit{See} Mark J. Roe, \textit{Delaware's Competition}, 117 HARV. L. REV. 588 (2003). \textit{See also} Mark J. Roe, \textit{Delaware's Politics}, 118 HARV. L. REV. 2491 (2005) (claiming that interest groups dominating Delaware lawmaking forgo a winner-takes-all strategy fearing that federal legislators may act if results are lopsided; and that state-level players want to minimize federal intervention in corporate law).}

The discussion below revolves around ten case studies that demonstrate how legislators \textit{actually} go about doing their business and achieving their regulatory objectives. These diverse cases illustrate how legislators and government officials strategically exercise their institutional mandate and rule-making power to exert legislative threats and ultimately, how these threats function as regulators of conduct.

1. \textit{Cyber-security}

Recently, officials from the Department of Homeland Security grew concerned with the inadequate security measures presently taken by the U.S. computer industry to make computer and network infrastructure sufficiently secure from the imminent risks of terrorist cyber-attacks.\footnote{120 Conveying the security concern, Tom Ridge, secretary of the Department of Homeland Security, said that "'[i]t only takes one vulnerable system to start a chain reaction that can lead to devastating results.'" \textit{See} John Markoff, \textit{U.S. Pressing Industry on Technology Security}, N.Y. TIMES, Dec. 4, 2003, at C8.} Seeking to address this concern, the officials convened about 350 computer executives and software developers to discuss these issues, share information on the risk of cyber-attacks, learn of the efforts currently being undertaken, and evaluate possible solutions to mitigate the problem.\footnote{121 The meeting took place at the National Cyber Security Summit that was sponsored by the Department of Homeland Security. Among those attending the Summit were technology companies and industry trade groups. \textit{See} Markoff, supra note 120, at C8. As I demonstrate in Part III(C), the presence of trade organizations bears significant impact on the incentives of industry participants to comply with the threat.}

Having examined the nature of the problem, the officials \textit{warned} the captains of the computer industry that either they step up to the plate and voluntarily align their practices with the standards that the Department of Homeland Security considers necessary to guard against the risk of cyber-attacks or the officials would seek to enact into law an adverse legislative measure. Among other things, the threatened legislation would regulate the conduct of these companies, impose minimum security standards, and secure a desirable solution to this social concern.\footnote{122 \textit{See} Markoff, supra note 120, at C8 (describing the meeting between the government officials and the industry participants and the information they exchanged). A draft legislative proposal would have also required companies to disclose their security status in the financial reports they file with the SEC. Presumably, poor security status would have been priced by the financial market, thus affecting the market value and stock price of these companies and increasing their cost of capital.}
The officials’ threat of legislation followed the National Strategy for Secure Cyberspace that the government had issued a year earlier in order to improve the security of computer networks. Silicon Valley executives claimed, however, that the Strategy had not been given sufficient attention and proper priority at the industry level. Indeed, “many specific propositions ... were reportedly eschewed at the request of an industry hesitant to being forced to do anything.”

Underscoring the threat, the officials bluntly stated that “[t]here are a lot of people who are willing to legislate. If that’s what you want, I can promise you that’s what you’re going to get.” Plainly, this story demonstrates the use of an explicit legislative threat. The captains of the computer industry (i.e., the threat-recipients) were presented with a binary choice. They could either strictly comply with the demands or face the risk of adverse legislation and suffer its negative consequences. No doubt, the officials got their way, as industry executives reacted by saying that the “administration’s message had been unambiguous.”

In response to the impending threat, four major business associations that were present at the Summit formed an industry-wide group (aptly labeled the National Cyber Security Summit Alliance). They formed five specialized working groups to study the security problem, devise measures to reduce vulnerability, and to develop a specific plan. This Alliance, which vowed to have “initial deliverables” by a specific date, was the first significant step towards fending off the legislative threat.

2. E-Piracy

Electronic piracy is one of the least desirable offshoots of technological progress in an information-based economy. In recent years, the prospects of e-piracy over the Internet have given rise to another area of regulatory concern, as piracy threatens to reduce Internet traffic, undermine e-commerce, impose significant anti-piracy costs on

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124 See News Release: U.S. Businesses Promise Security Plan by March 1, 2004, SCOTLAND IS, at http://www.scotlandis.com (last visited Feb. 10, 2004). Furthermore, “[s]ince the Bush administration released its National Strategy to Secure Cyberspace ... there has been a lot of talk about how to implement it, more calls to action ... and not a great deal of concrete activity.” Id.
125 Id. (emphasis added).
126 Legislative threats are classified into three categories which include explicit threats, implicit threats, and anticipatory threats. A detailed discussion is presented in Part II(B) below.
127 A chief executive who attended the Summit stated that “[c]learly the message was that if private enterprise doesn’t start embracing this, more is to follow.” Id.
128 Microsoft Inc., through its Chief Security Strategist, led the most important working group in charge of putting together technological measures to actually secure the software that potential cyber-terrorists would exploit. Surely, this reveals Microsoft’s assessment of the harsh consequences that an adverse legislative measure would entail for the industry as a whole and for Microsoft in particular.
129 See News Release: U.S. Businesses Promise Security Plan by March 1, 2004, supra note 124 (“It seems that the threat of legislation has kicked-started things”).
130 Id. (the Alliance created a public-private self-regulation partnership).
businesses and consumers, and thwart consumer benefits from increased economic competition. In an attempt to address this concern, the Federal Trade Commission’s threat to legislate e-privacy standards induced commercial Internet sites to self-regulate so as to protect consumers.132

In 2002, responding to worries about the unauthorized sharing of digital media, the Federal Communications Commission stepped into the arena of e-piracy in an effort to prevent piracy via digital TV. The concern focused on the piracy of copyrighted content and the unauthorized distribution of such content over the Internet for use by others. To address the problem, FCC regulators decided to mandate, as a minimum standard, the use of “broadcast flag” technology that was uniquely designed to prevent piracy of digital signals.133 The FCC also invited comments on a variety of topics and issues related to this proposed measure. Giving a clear signal that the FCC was keen on taking an action to halt e-piracy, the FCC’s Commissioner warned that the decision should “make clear to various industry stakeholders that they have only a small window to reach agreement . . . or they will face a solution imposed on them in the near-term future.”134 This statement rendered the legislative threat unambiguous.

The FCC’s regulatory threat—namely, the decision to impose mandatory technological measures unless the industry devised a voluntary solution—followed an earlier threat. Working with both Republican and Democrat co-sponsors,135 Senator Ernest Hollings, who chaired the Commerce and Science Committee, introduced a bill that would have required Silicon Valley technology firms and Hollywood entertainment and content producers to agree on a standard to stop digital piracy of copyrighted content.136 According to the Hollings bill, the government would step in and mandate a solution if the industry did not reach an agreement within one year. Stating that the “the two sides needed the threat of legislation to make further progress,” Senator Hollings issued an explicit threat and circulated draft versions of the threatened legislation to high-tech and media companies aiming to induce an industry-engineered solution.137 The Hollings bill was introduced only after hearings that had been held before the Commerce and Science Committee had been unsuccessful in

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132 See Mary Mosquera, FTC Threat to Regulate E-Privacy Gets Real, TECH WEB, May 30, 2000, at http://www.techweb.com/wire/story/TWB20000530S0006 (FTC “had used the threat of legislation as a cattle prod . . . to get more commercial Internet sites involved in self-regulation”).

133 “Broadcast flag” technology is a sequence of digital bits that instruct electronic devices not to play pirated content. With this technology in place, consumers could make copies for their own use but would be prevented from distributing the copyrighted material over the Internet.

134 See Stephen Chiger, FCC Steps into Digital Copyright Debate, PCWORLD.COM, Aug. 8, 2002, at http://www.pcworld.com. The FCC’s decision, it was reported, “represents new government pressure for industry groups to create [a] system on their own for digital rights management.” Id.

135 Co-sponsorship may bear significantly on the credibility of the legislative threat and therefore on the compliance incentives of firms and the inducement effect of the threat.


137 Id. Senator Hollings added that “[g]iven the pace of private talks so far, the private sector needs a nudge. The government can provide that nudge.” Id.
reaching an agreed-upon solution. Instead, media companies including Disney Inc. used those hearings to accuse technology firms, including Intel Inc., of profiting from digital piracy. Such non-cooperative behavior rapidly became cooperative once a legislative threat was issued. The companies began negotiating the standard technology in the shadow of this threat.

3. Digital Obscenity

Recently, the House Judiciary Committee’s Copyright Subcommittee launched an investigation into a dispute between the Directors Guild of America (DGA), a representative body of directors and film studios that make up the U.S. movie industry, and a Utah-based manufacturer that sells DVD players capable of editing out sex, profanity, violence, and foul language from films. The dispute arose because, arguably, editing-out such materials violates artistic copyrighted content. The Judiciary Committee expressed the interest that the industry and the manufacturer end the dispute. The Committee’s chair threatened to introduce formal legislation to address these issues and solve the dispute if the parties did not reach an agreement. The threat was subsequently “renewed … when DGA representatives met with the lawmaker and his staff” and “were made aware of Congressman Smith’s [i.e., the chair of the Copyright Subcommittee] intense interest” in having that matter resolved. Lo and behold, threats induced Hollywood (notwithstanding the lawsuit it had filed to enjoin the violating conduct) to enter into negotiations with the company in an attempt to reach a satisfactory solution and avert the risk of legislation.

4. D&O Compensation

The terms governing the appointment, compensation, and removal of officers and directors in public companies are an important dimension of corporate governance. The correlation between pay and performance (or a lack thereof) has attracted a great deal of public interest in the wake of the unprecedented corporate fraud scandals that broke out in Enron and WorldCom (in the U.S.) and Parmalat (in Europe).

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138 Disney CEO Michael Eisner considered the Hollings bill a positive development, reasoning that the “‘bill provides the needed discipline of a deadline for the conclusion of industry negotiations.’” Id.


141 See generally Lucian Bebchuk & Jesse M. Fried, Pay without Performance: The Unfulfilled Promise of Executive Compensation (2004) (structural flaws in corporate governance enable managers to influence their own pay, prevent corporate boards from negotiating at arm’s length with the executives they are meant to oversee, produce widespread distortions in executive pay, and decouple compensation from performance).

142Fraudulent corporate conduct has different manifestations in the U.S. than in Europe. For a comparative discussion of such scandals, earnings management, and financial irregularities see John C. Coffee, Jr., A Theory of Corporate Scandals: Why the U.S. and Europe Differ (COLUM. L. & ECON. WORKING PAPER NO. 274, 2005) (dispersed ownership governance systems that characterize U.S. public companies are prone to earnings management, while concentrated ownership governance systems that are typical in European companies are
Entrenchment of board members (known as “classified boards”) and the ensuing insulation of management from removal have since been looked at unfavorably.143

It is precisely against this backdrop, that investor rebellion over a potential £22 million payoff to the poorly-performing CEO of the pharmaceutical giant GlaxoSmithKline and large payments to directors at the telecom company Marconi (notwithstanding the company’s business failures), led members of the U.K. Parliament to realize that increased pay-performance sensitivity is needed.144 To that end, MPs directed a clear threat of legislation to public companies seeking to end these practices.145 If enacted, the legislation would require that companies stop rewarding ineffectual directors who failed to promote the best interests of their shareholders.146

This legislative threat changed the corporate landscape in Britain, forcing public companies to reduce the length of directors’ contracts and forge a close link between compensation and performance. In order to ensure sustained compliance with the threat, the parliamentarian corporate governance committee in charge of these issues noted that “[t]he threat of legislation against boardroom excess should be left hanging over big companies if they refuse to end ‘rewards for failure’ voluntarily.”147

5. Money Laundering

Seeking to deter organized criminal activity, governments adopt measures that are designed to reduce the benefits from committing such crimes.148 Bans on money laundering—i.e., the use of complex transactions and transfers of money through financial institutions to conceal the ultimate source of money holdings—may provide an effective deterrent.149 In addition, anti-laundering measures have gained renewed global interest as a counter-terrorism measure.150 Given the machinations of money

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143 Lucian Bebchuk & Alma Cohen, The Costs of Entrenched Boards, 78 J. FIN. ECON. 409 (2005) (staggered boards, which substantially insulate boards from removal in either a hostile takeover or a proxy contest, are associated with an economically meaningful reduction in firm value, as measured by Tobin’s Q).


146 Concerns over excessive director and executive compensation arose in the U.K. in the mid-1990s. At the time, a corporate governance committee headed by Sir Richard Greenbury, the Marks & Spencer chairman, was appointed to recommend appropriate practices. Sir Greenbury is reported to have said in that respect that “[i]f [corporate boards and executives] don’t accept the main thrust of the [committee’s] report they will get legislation.” See Kirstie Hamilton, Fat Cats Maul Greenbury, THE TIMES, Dec. 3, 1995, available at http://www.lexis.com (internal quotations omitted).

147 See Treanor, supra note 145. While the Department of Trade and Industry did not advocate legislation, it kept it as an option, stating that “[i]f the wishes of shareholders are not being adequately reflected in contracts being agreed by companies’ remuneration committees [] legislation will need to be reconsidered.” Id.


149 See “Money laundering,” in Black, supra note 50, at 305.

150 See E. Anthony Wayne, Money Laundering and Terrorist Financing in the Middle East and South Asia,
laundering, banks and other financial institutions are the ultimate gatekeepers as they are best-positioned to monitor money transfers, detect suspicious activity, and report such incidents to enforcement agencies. Short of strict enforcement, however, such bans remain virtually ineffective. Furthermore, imposing fines and other sanctions to enforce anti-laundering measures on financial institutions that fail to comply is a difficult task which requires substantial information that is not readily-available to enforcement agencies. For this reason, anti-laundering has been governed by banks’ self-regulation.

Nevertheless, banks and financial institutions may fail to serve the gatekeeper function. Apart from the aforementioned monitoring and detection, enforcing bans on money laundering involves policing costs which consist of training and personnel expenditures as well as IT investment. In addition, banking and financial institutions employing anti-laundering monitoring are likely to crowd-out certain clients, thus losing additional business, lowering the volume of banking and financial transactions, and suffering lower gross profits.151 Hence, it should come as no surprise that bankers and other financial professionals may opt to turn a blind eye to their customers’ activities, thereby aiding in the camouflage of an illegal source of money. Confirming this concern, the economic secretary to the U.K. Treasury accused financial advisers of “‘willful blindness’” to illicit funds and warned of their practice of “not asking too many questions,” which facilitated the rendering of services that “‘obscured the relationship between the money and the man’” behind it.152

Coupled with indications that banking, accounting, and law firms in the U.K. were perceived as being complacent with respect to laundering, these problems fueled the U.K. government’s threat to legislate if banks and other financial institutions did not voluntarily devise and adopt a stricter self-regulatory regime to control and prevent money laundering. Reinforcing the government’s threat, the U.K. Treasury signaled that it would consider a tougher, prescriptive approach to controlling the transfer of gains from criminal activity if the private financial sector would not step up to the task. To ensure the threat’s wide dissemination, members of the British Bankers Association, the industry’s trade association, were informed of the government’s strict policy objectives. According to the threat, the industry, which indeed started to review its methods of detection, was expected to provide the Treasury revised plans for money-laundering monitoring programs.153 However, if it was determined that these proposals

151 See Donato Masciandaro & Umberto Filotto, Money Laundering Regulation and Bank Compliance Costs: What Do Your Customers Know? Economics and the Italian Experience, 5 J. MONEY LAUNDERING CONTROL 133 (2001) (examining the link between the effectiveness of the anti-laundering regulations and the characteristics of the relative compliance costs for banks, focusing in particular on the implications for bank-customer relationships).

152 See Legislation Threat to Banks’ Self-Regulation, PRIVATE BANKER INT’L, June 1, 1998 (reporting the government’s concern over widespread money laundering and the financial sector’s perceived complacency).

153 The government not only threatened to introduce strict legislation but also to bring to an end the long-standing tradition of financial self-regulation. The risk of abolishing self-regulation in this sector may have augmented the risk of strict legislation on money laundering and the adverse effects resulting from high compliance costs that banks and other financial institutions will have to incur.
were unacceptable, the government would legislate and replace self-regulation with formal regulatory codes.

6. Hazardous Waste Recycling

As environmental hazards become widespread, policy concerns relating to disposal of toxic materials, recycling of hazardous waste, and emissions of environmentally-harmful gasses, to take but a few examples, have attracted a great deal of legislative and administrative attention in recent years. The ever-increasing interest in controlling such problems and the complex task of prescribing economically-feasible measures, gave rise to a widespread use of legislative threats on the national and state levels.

The personal computers industry, which uses lead, mercury, cadmium, and other toxic metals to manufacture computers and other electronic devices, has been the target of numerous legislative threats concerning the recycling of such hazardous components. As environmental activists have repeatedly accused the industry of not doing enough to curb the problem and of shirking a responsibility to safely dispose of the hazardous materials it uses, state and national legislators realized that companies would not do anything substantial unless they are required to. In turn, that has led legislatures to introduce proposed legislative measures in more than twenty states. The European Commission, too, has issued a draft directive with the goal of promoting the recycling and recovery of electronic waste.  

As expected, “the threat of legislation has PC companies … scrambling to come up with a system that is voluntary but still effective.” Specifically, companies have realized that they, rather than legislators, are far better-positioned to devise effective solutions. Precisely to that end, PC manufacturers joined forces to form the National Electronics Product Stewardship Initiative, a working group designed to reach a consensus on the recycling problems of hazardous materials.

7. Greenhouse Gas Emissions

Greenhouse gas emissions have also become a reason for concern. Indeed, the undesirable impact of gas emissions on global warming has occupied the Environmental Protection Agency’s (EPA) regulatory agenda for quite some time now. Seeking to reduce and control greenhouse gas emissions, the EPA entered into agreements with semiconductor manufacturers that emit greenhouse gasses in

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156 See Harrison, supra note 155. “PC makers say a voluntary approach gives them more opportunity to find marketable ways to turn their industry green.” Id.

manufacturing integrated circuits. These agreements represent the industry’s response to the EPA’s threat of inopportune legislation to control gas emissions.

Fearing the potentially-intrusive and economically-unfeasible requirements of adverse legislative measures, companies in the industry seem to find refuge in agreements they negotiate in the shadow of legislative threats. Such accords allow them to adopt environmentally-responsible and cost-effective solutions. Echoing this notion, a Lucent Technologies’ representative stated that “[o]ur collaboration with the EPA will reduce greenhouse gases in a way that makes sense from both a business and an environmental standpoint—without regulation or mandate.”

8. Auto Air-pollution

Low air-pollution targets have been a long-standing environmental goal for the auto industry. Underlying this goal is the understanding that carbon-dioxide, a greenhouse gas which cars belch into the atmosphere, causes undesirable worldwide climate changes. In early 2004, it was discovered that the auto industry was secretly lobbying the European Commission to relax air-pollution targets, arguing that strict targets would impose high costs, threaten the competitiveness of the car manufacturing industry, and harm the EU economy.

Responding to this untoward development, environmental groups demanded that the European Commission upholds previously-set targets and advocated resorting to legislative threats. The groups reasoned that “[p]ast experience tells us that the threat of legislation is the best way to stimulate real improvements and technological innovations” to achieve environmental targets. The industry’s representative body, as I explain in Part III(C) below, plays an important role in ensuring compliance by industry participants with the legislator’s demands.

9. Commercial Leases

During the 1990’s, the U.K. government grew concerned over unfair terms and clauses in commercial leases in England and Wales which placed business tenants under strict, potentially-harmful obligations. Of particular concern was the burden of upward-only rent reviews. Responding to the government’s concerns, in 1995 a cross-industry working group drafted a voluntary code of conduct that included 23 recommendations. The code guided both the conduct of landlords and tenants in

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158 Leading semiconductor manufacturers, including Lucent Technologies, Advanced Micro Devices, Hewlett-Packard, Intel, and IBM to name a few, have entered into such agreements with the EPA.


160 To advance its cause, the industry acts through a representative body, the European Automobile Manufacturers Association, that represents all major car manufacturers. Members of the Association include Ford, General Motors, DaimlerChrysler, BMW, Fiat, Renault, Peugeot, Citroen, Volvo, Volkswagen, and others.


162 See Janet Higbee, Cripps Alert: Commercial Property Law, at http://www.e-cripps.co.uk (June 2, 2004).
negotiating new business tenancies and their behavior throughout the duration of the lease. Designed to promote flexibility and fairness in business leases, the code addressed a variety of issues including assignment and subletting, rent reviews, insurance, default management, and dispute resolution.\footnote{See A Code of Practice for Commercial Leases in England and Wales (2d. ed., 2004), available at http://www.commercialleasecodeew.co.uk.}

As the code was a non-binding set of rules, its success depended on the nonobligatory implementation by landlords and tenants. As one could have expected the code was largely ignored, thus failing to achieve its intended objectives. In response, the government issued a threat of legislation in 2001, according to which minimum safeguards to protect the interests of business tenants will be enacted unless property owners and tenants devise a voluntary solution to introduce more flexibility into commercial leases.\footnote{See Angela Jameson, Threat of New Law on Property Leases, THE TIMES, Apr. 5, 2001 (“The property industry faces the threat of legislation to outlaw the lease at the heart of the UK’s commercial property market”).} Seeking to convey a serious message to the property sector, the government accompanied the threat with a clear, two-year trial period in which to implement the code on a voluntary basis. If the code was not implemented within that period to the government’s satisfaction, the government would move and pass formal legislation. Furthermore, in order to monitor compliance with the legislative threat, the government appointed various bodies to oversee code implementation.\footnote{The government appointed Reading University to monitor code implementation. According to the appointment, the University was to report to the government its assessment of the code implementation. In addition, the British Property Federation was appointed to monitor implementation on behalf of the property sector. See Monitoring Proforma for Commercial Leases Code of Practice, in BRITISH PROPERTY FEDERATION: COMMERCIAL LEASES CODE OF PRACTICE RESOURCES, available at http://www.bpf.org.uk (last visited Jan. 2, 2006).} No doubt, this explicit legislative threat engendered compliance with the code.

\section*{10. Illegal Substances}

The use of illegal substances in sports is another area in which legislative threats have been employed to regulate conduct and promote public policies. Representative John Sweeney introduced in 2002 a bill to control the use of steroid-like substances. The bill did not have much impact until the issue gained broad attention and threats to legislate were made clear. The use of steroids and other performance-enhancing drugs by professional athletes has become a major issue following the fatal overdose of a baseball player. In hearings before the Commerce Committee and as congressional clamor intensified, senators pressured baseball officials to take the actions necessary to stop the widespread use of such substances. Senator John McCain, the chairman of the Senate Commerce Committee, warned baseball officials that “he would begin looking for legislative remedies because ‘the status quo is not acceptable.’”\footnote{See Jim Puzzanghera, Congress Targets Sports in Crackdown on Steroids, MERCURY NEWS, Mar. 27, 2004, available at http://www.mercurynews.com.} Senator McCain explained that holding the high-profile hearings been an attempt to coerce the baseball league to act. Clearly, the highly-visible hearings signaled to baseball officials the seriousness of the threat and the keen interest of legislators to act on this issue.
Contributing to the legislative dynamics, in 2004 Representative Jim Sensenbrenner, the chairman of the House Judiciary Committee, sponsored the House bill banning steroid precursors, thus reinforcing the social concern and augmenting the legislative pressure on baseball officials. While Representative Sensenbrenner formally disagreed with Senator McCain’s explicit threat to legislate in this area, his proposed bill was in fact an implicit threat itself. Representative Sensenbrenner, who accused the baseball players’ association of not responding to calls for tougher steroid testing, stated “I don’t think that the players’ union has gotten the message, but they’re getting it.”

Responding to the Committee’s legislative threat and the increasing squeeze from Congress, the Baseball Commissioner announced that the baseball league had decided to ban the use of THG, a steroid players use to evade detection in steroid tests. Yielding to these threats, baseball officials also undertook to institute stricter steroid testing and to impose harsher sanctions on players using such substances.

B. An Analytic Taxonomy of Legislative Threats

The case studies presented above, demonstrate the prevalent, strategic use of legislative threats as regulators of social conduct across diverse sectors of society. Mindful of the novelty of legislative threats, I devote the discussion that follows to laying a solid conceptual basis and to offering an analytic system by which to classify legislative threats as evidenced in the aforementioned case studies. Specifically, I develop a workable, analytically-precise taxonomy of threats in order to better understand observed variance in the landscape of legislative threats. Analytically, I distinguish between three categories of legislative threats: (i) explicit, (ii) implicit, and (iii) anticipatory. In the interest of practical and theoretical inclusiveness, this classification is neither context-specific, nor is it uniquely-related to social control in any particular legal system or rule-making hierarchy. Rather, the taxonomy encompasses observations of legislative threats in various contexts of social and economic activity and across different legal systems. This taxonomy renders the novel concept of legislative threats a practical analytic tool that lends itself to investigating the intricate landscape of modern social control, where formal legislative measures and informal legislative threats partake in regulating social behavior.

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168 The analytic and functional differences between explicit, implicit, and anticipatory legislative threats are analyzed and examined in greater detail in Parts II(B)(1)-(3) respectively.
169 See Frommer, supra note 167.
170 See Puzzanghera, supra note 166. Further demonstrating the government’s interest in bringing steroid use to an end, Attorney General John Ashcroft announced the indictments of several people charged with providing illegal substances to athletes. Furthermore, the Food & Drug Administration ruled that THG was an illegal substance; and Health & Human Services Secretary Tommy Thompson publicly warned 23 companies to stop selling and marketing a steroid known as androstenedione. Id.
171 In addition to the risk of adverse steroid legislation that ensures compliance with the legislative threat, Major League Baseball is also subject to the risk that Congress may revoke its exemption from federal antitrust laws. In fact, Congress has threatened to revoke the exemption in the past but has never followed through. For this reason, “sport executives pay attention when Washington gets upset.” Id.
This classification is not merely an intellectual exercise meant to enhance the analytic precision and understanding of this legislative phenomenon. On the contrary, this classification carries significant practical value in its ability to delineate the actual boundaries of the concept and draw attention to the seemingly-disparate manifestations of legislative threats. In other words, this taxonomy allows for the necessary inclusion of the less obvious implicit and anticipatory threats (without which, any account of the scope of legislative threats would have been limited to the more obvious explicit threats and therefore would have remained incomplete). In sum, this classification aids in clarifying the many instances of legislative threats that would otherwise go unrecognized, thus illuminating the actual magnitude of this phenomenon.

While a common conceptual thread links all legislative threats, the observed variance between these threats leads to the three analytically-distinct categories mentioned above. As I will explain in Part III, this variance is outcome-determinative. That is, the analytic taxonomy pinpoints the variables that determine (and that can be used to predict ex ante) the likely effectiveness of a legislative threat in inducing a change in behavior and, therefore, in achieving predetermined policy objectives. In other words, the inducement effect of threats on behavior depends among other things, on whether the threat qualifies as explicit, implicit, or anticipatory. Hence, this classification derives insights without which the complex mechanism underlying the inducement effect of legislative threats would remain inscrutable. It is precisely for these reasons, that gaining insight into the various types of legislative threats and their respective inducement effects is indispensable in advancing this theoretical inquiry.

1. Explicit Legislative Threats

Explicit threats are the quintessential manifestations of legislative threats. As a matter of definition, a threat qualifies as explicit when a legislator communicates an unambiguous threat to a group of recipients. According to the threat, legislators will introduce a bill and seek to enact adverse legislation unless the entities to which the threat is directed, comply with the demands that are embodied in the threat.172

Doing precisely this, Homeland Security officials convened the captains of the computer industry and leading trade groups to discuss government concerns of cyber-attacks and to explicitly communicate a legislative threat.173 Similarly, in an effort to ensure that the threat to legislate anti-money laundering measures be widely disseminated, the U.K. Treasury informed members of the British Bankers Association (the industry’s trade association), of the government’s strict policy objectives.174 In

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172 A clear and unambiguous expression of a legislative plan to enact formal legislation in the absence of compliance is not necessarily credible; in some circumstances, threats are merely “cheap talk.” The conditions that make legislative threats credible or incredible are examined in great detail in Part III(B) below.

173 Underscoring the legislative threat, the officials blatantly stated that “[t]here are a lot of people who are willing to legislate. If that’s what you want, I can promise you that’s what you’re going to get.” See Markhoff, supra note 120, at C8 (describing the government-industry interaction and the exchange of information). For a detailed discussion of this legislative threat see Part II(A)(1) above.

174 See Legislation Threat to Banks’ Self-Regulation, supra note 152 (describing the dissemination of information to the financial sector to which the threat was directed).
another example, the sponsoring legislator of an explicit threat to halt digital piracy circulated draft versions of the proposed bill to high-tech and media companies. The threatened Senator forewarned that “‘[g]iven the pace of private talks so far, the private sector needs a nudge. The government can provide that nudge.’”

While their particular manifestations may vary from one case to another, explicit threats have common characteristic features. Normally, legislators exerting explicit threats reveal substantial and unambiguous information about their serious interest in controlling the conduct in question. Legislators also express the social-desirability of the reform that the threatened legislative measure is designed to achieve. In an attempt to endorse the desired reform, legislators typically spell-out the significant social stakes that will likely be affected if a change in behavior is not achieved.

Explicit threats convey both a legislator’s unequivocal concern with the negative externalities of a given conduct and his intention to exercise his legislative mandate to control that conduct and align it with the social interest. In other words, exerting an explicit threat inevitably means that the legislator publicly commits himself to pursuing the advocated reform by means of legislation in the event that the recipients of the threat do not comply with the articulated demands.

Moreover, explicit threats typically espouse—and, to a large extent, are predicated on—a concrete and often well-developed contingent legislative plan. That is, the plan of legislative action will be executed if and only if the recipients of the threat do not voluntarily change their conduct and modify their practice in conformity with the legislator’s demands. Often, these contingent plans outline implementation procedures and set forth compliance deadlines, thus clarifying the steps and time-line that threat-recipients must follow in order to avert the risk of adverse legislation.

For example, giving a clear signal that the FCC was keen on taking an action to stop piracy, the FCC’s Commissioner warned that “‘industry stakeholders … have only a small window to reach agreement … or they will face a solution imposed on them in the near-term future.’” With respect to compliance procedures, the U.K. government’s threat to legislate anti-laundering measures, required the financial sector to provide the

\[175\] See Bill would Prevent Sharing of Digital Music, Video, supra note 136.

\[176\] The reference to legislators’ interest does not suggest that the interest in controlling a given activity is imputed to the legislative body as a whole. Rather, this interest may relate for example only to a few members of the legislative body or to one party.

\[177\] The analysis in Part III explains how the information that legislators convey to the recipients of the threat signals the seriousness and credibility of the threat.

\[178\] The legislator’s public commitment is not necessarily believable. In other words, the threat to enact adverse legislation if the threat is not complied with is not necessarily credible. The conditions making a legislative threat credible or, rather, incredible are examined and discussed in Part III below.

\[179\] A legislative threat can be made at different junctures of the legislative process. For example, the threat may accompany: a preliminary announcement of the interest in legislation; a blueprint legislative proposal; or a proposed bill that (according to the threat) will be brought to a floor discussion before a plenary session of the legislative body unless the demands are complied with.

\[180\] In this respect, explicit threats are the end-product of measures that members of the legislative body have taken to implement their social control agenda.

\[181\] See Chiger, supra note 134. A detailed analysis of this threat is found in Part II(A)(2) above.
Treasury with revised plans for monitoring programs, which were then to be reviewed by the government in order to ensure adequate compliance.\footnote{See Legislation Threat to Banks’ Self-Regulation, supra note 152 (describing the terms of the legislative threat that the U.K. government directed to banks).}

Nonetheless, explicit threats differ with respect to the amount of information they divulge regarding the contents and features of the threatened legislation, thereby potentially leaving a degree of uncertainty. While some legislators opt to describe the contents of legislation or, in some cases, have already introduced a proposed bill that inevitably reveals that information, others may choose to disclose only general information. These observations confirm one’s intuition that legislators strategically choose how much information to impart and, more importantly, what to make public and what to keep private. As I explain in greater detail in Part III, the revelation of pertinent information carries important strategic implications that bear decisive impact on the effectiveness (or ineffectiveness) of the legislative threat.

In summary, the hallmarks of explicit legislative threats include the following elements: (i) explicit communication of an unambiguous threat; (ii) articulation of a contingent legislative plan, typically laying out implementation procedures and setting forth compliance deadlines; (iii) expression of the legislator’s intense interest in controlling the conduct in question and the compelling case for the proposed reform; and (iv) disclosure of certain information concerning the contents and features of the proposed legislation.

2. Implicit Legislative Threats

Legislators seeking to induce a change in behavior need not necessarily exert a legislative threat in explicit, overt terms. For, threats of any kind, legislative threats included, can equally be of an implicit nature. Indeed, the strategic use of implicit threats constitutes an interest for researchers in various fields of theoretical inquiry including, among others, industrial organization and antitrust.\footnote{Industrial organization and antitrust theorists, to take two examples, study the use of implicit threats by incumbent firms. These firms may employ threats in order to implement a variety of strategies designed to deter the entry of a potential rival into the market, to drive rivals out of the market, or to reduce the portent of the rival. In addition, firms may use threats to force existing competitors into a collusive, price-fixing arrangement. Firms may communicate such implicit threats through vigorous price cutting, which signals their intention to engage in cut-throat price competition (i.e., predatory pricing) unless the firm (or firms) to which the threat is directed, complies with the threat (e.g., avoids entry or enters into a collusive arrangement). See Dennis W. Carlton & Jeffrey M. Perloff, Modern Industrial Organization 79-80, 333-61 (3rd ed. 2000) (firms may use a variety of threats to maximize profits by improving their market position relative to their rivals).} Implicit threats can be understood as nothing more than one particular instance of unspoken behavior.\footnote{Another example of unspoken behavior is tacit collusion—the coordinated actions of firms despite the lack of an explicit, formal cartel agreement. A tacit collusion, in which firms refrain from undercutting each others’ prices or from selling in each others’ areas, is necessarily implicit because antitrust laws (e.g., Section 2 of the Sherman Act) make explicit cartel agreements illegal and thus unenforceable. See Carlton & Perloff, supra note 183, at 134 (defining tacit collusion). See also “Collusion,” in Black, supra note 50, at 66 (same).}

While it may be easier to illuminate the elusive notion of implicit legislative threats by describing actions that do not qualify as such, I go further than this and describe the
presence of actions that constitute an implicit threat, so as to delineate the conceptual perimeter. To put it simply, the notion of implicit threats refers to circumstances in which the actions of legislators signal a threat without either an explicit exertion or a communication of a contingent legislative plan (i.e., a commitment or promise to legislate if compliance is not otherwise obtained). In such instances, the entities to which the implicit threat is meant to apply neither face a formal demand to modify their conduct (let alone a compliance deadline), nor are they warned that failure to do so will put them at risk for unfavorable legislation.

Of particular importance is the fact that, in contrast to their explicit counterparts, implicit threats contain no publicly-stated promise to pursue a particular reform by means of legislation. Whereas explicit threats necessarily involve the legislators’ commitment to pursuing the advocated reform by means of legislation (that is, if the recipients of the threat do not voluntarily comply with the threat), implicit threats encompass no commitment whatsoever. It can be said that implicit threats and public commitments are mutually-exclusive.

Furthermore, legislators relying on implicit threats to advance their social control agenda do not normally convey much information regarding their interest in regulating a particular behavior or the gravity of the underlying concern. In keeping, legislators normally do not disclose information concerning the contents and features of the threatened legislation although, admittedly, this varies from one case to another.

Consistent with other instances of unspoken behavior, implicit threats can be determined based on the acts and behavior of legislators at different temporal junctures. Firms may infer the “issuance” of such threats from the legislator’s effort to further his legislative agenda. A signal of an implicit threat can take the form of: introducing a proposed bill; executing preparatory work necessary to enact legislation (e.g., gathering data); and handing-out drafts to the targets of such legislation. These acts may be particularly indicative of an implicit threat if the legislator has a track-record which establishes his reputation for using such threats. Needless to say, not all proposed bills necessarily signal implicit legislative threats. Whether an implicit threat exists or not depends, among other things, on the information available to potential threat-recipients who may use it to ascribe practical meaning to the observed actions.

185 In the absence of an explicit threat, a contingent legislative plan becomes virtually meaningless. Of course, the legislator may pursue some predetermined legislative plan but that plan is not explicitly and publicly conditioned upon the conduct of the entities to which the threat implicitly applies.

186 But see Markhoff, supra note 120 (“Federal officials made clear ... that private industry must make progress in voluntarily comply with the Bush administration’s national cybersecurity plan or face new legislation requiring compliance”).

187 A contingent commitment to legislate is the hallmark of explicit threats. See, e.g., Jameson, supra note 164 (U.K. Planning Minister announced “he [would] impose legislation if a voluntary agreement is not reached”).

188 While legislators may express their significant interest in controlling the conduct in question, conveying such information is not inconsistent with the concept of implicit threats insofar as the interest is not publicly tied to any commitment to enact legislation.

189 In such instances, the implicit threat is simply a pre-mature explicit threat, that is, a threat that has not been formalized into an explicit threat.
Another way a legislator can express a threat is by sharing information in meetings and conventions held with firms, organizations, and industry leaders. Providing information in the shadow of a pending legislation proposal will likely reinforce the implicit threat. In certain circumstances the slow pace at which legislators work to advance legislation can be viewed as an opportunity (indeed, an invitation) to comply with an implicit threat so as to dodge the risk of damaging legislation.

Because implicit threats are inferred, not explicitly communicated, uncertainty concerning whether a threat has in fact been made is all but inevitable. In an attempt to resolve this uncertainty—and, indeed, to play it safe in case a credible implicit threat is actually at stake—firms may modify their conduct so as to bring it in line with the implicit demands. Lowering the priority of a pending legislation or postponing the legislative process in response to observed changes in the conduct of targeted entities, will undoubtedly signal an unequivocal threat. In other words, freezing the legislative process, even temporarily, in response to perceived behavior modification, reveals the inverse correlation between the proposed legislation and the industry’s conduct. This interrelation affirms that an implicit threat is at work.

In light of the foregoing taxonomy, the choice between implicit and explicit legislative threats merits attention. Why, and under which circumstances, would a legislator favor one type of threat over the other?

Careful examination of the underlying motivations reveals that a number of factors may affect this choice. For example, a legislator may be reluctant to exert an explicit threat thereby putting his precious reputation to the test, in the fear that the risk of failing to pass the promised legislation in Congress will adversely affect his reputational capital. Surely, risking one’s reputational capital may involve harsh consequences insofar as the legislator’s reputation is essentially a mechanism that enables the making of credible (i.e., believable) commitments. Thus, in the face of

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190 See Stephen Bell, ISPs Get Code but Not Everyone Likes It, COMPUTER WORLD, July 2, 2003, at http://www.computerworld.co.nz (describing an information-exchange meeting and notes that “the mood of the meeting appeared to be that it was better to play it safe”).

191 In analytic terms, uncertainty concerning whether an implicit threat has already been made is consistent with an implicit threat scenario, uncertainty as to whether a threat will be made in the future gives rise to an anticipatory threat. The latter kind of threat is analyzed in the Section that follows below.


193 Needless to say, the legislator’s choice of regulatory strategy is by no means limited to explicit and implicit legislative threats, nor is it limited to threats alone. Rather, the legislator may choose to introduce legislation without any recourse to legislative threats of any kind. While this is true, the present discussion focuses on the binary choice between explicit and implicit threats. The general, binary choice between formal legislative measures and informal legislative threats, and the various functional and institutional considerations that shape this choice are discussed in great length in Part IV.

such consequences, the legislator may run the risk of inducing voter dissatisfaction, losing corporate campaign contributions,195 or the ability to extract rents in the future,196 all resulting in a decreased probability of reelection. Clearly, a well-established reputation (i.e., track-record for following through on threats), is a valuable strategic asset that a legislator can call upon to prompt compliance with future threats, thus further enhancing his reputation.197 As implicit threat involves no public commitment to legislate, employing this strategy buys the legislator reputational immunity, which guarantees no risk to the legislator’s reputational capital.198 For, in the absence of a public promise, there can be no backlash for failing to take the necessary actions, let alone for not neglecting to keep one’s word.

Likewise, a legislator may favor an implicit threat over its explicit counterpart in order to reduce potential political repercussions, which an explicit threat may provoke from fellow lawmakers. Such repercussions can serve to condemn what may be regarded as an improper or illegitimate use of legislative power.199 The use of implicit threats can be used to mitigate potential retaliation. Assuming all else remains equal, these considerations militate in favor of implicit over explicit threats.

But rarely do other things remain equal. As a matter of fact, the choice between explicit and implicit threats is outcome-determinative.200 Viewed from a legislator’s perspective, not only does the type of threat affect the risks and expected losses involved in exerting that threat, but it also strategically influences the likely inducement effect and therefore the benefits from using that threat.

3. Anticipatory Legislative Threats

The notion of anticipatory threats encompasses instances in which no threat has been made—neither explicit nor implicit—but where there is a risk that a threat may be

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195 Cf. Randall S. Kroszner & Thomas Stratmann, Congressional Committees as Reputation-building Mechanisms, 2 BUS. & POLIT. 35 (2000) (presenting data and showing that congressional standing committees foster repeated interaction between legislators and interest groups and facilitate reputation-building, without which legislators cannot maximize political contributions).

196 Cf. Fred S. McChesney, Money for Nothing: Politicians, Rent Extraction, and Political Extortion (Harvard, 1997) (special interest payments are often made not in return for political favors but rather to avoid political disfavors as part of a system of rent extraction).

197 Cf. Kevin T. Jackson, Building Reputational Capital: Strategies for Integrity and Fair Play that Improve the Bottom Line (2004) (reputation for credibility, fairness, integrity, responsibility, and other virtues is a form of capital often neglected in conventional business analyses).

198 Cf. Timur Kuran & Cass R. Sunstein, Availability Cascades and Risk Regulation, 51 STAN. L. REV. 683, 727 (1999) (“[A]n official who considers a waste spill innocuous may shade her knowledge simply to avoid being perceived as ‘weak on the environment’ in the event that the spill comes to be perceived as harmful”).

199 The discussion in Part V draws attention to normative dimensions of using legislative threats as regulators of conduct, including, among others, the inadequate procedural safeguards, the problem of democratic unaccountability, and the lack of institutional legitimacy. Hence, the use of legislative threats may give rise to disagreement and provoke political backlash from fellow lawmakers.

200 That a legislative interest in controlling a particular conduct has not been formalized into an explicit threat does not necessarily mean that such a threat is inevitably ineffective. The theoretical machinations that engender the inducement effect and the variables that affect its magnitude are analyzed in Part III(B) below.
issued in the future. In essence, these threats arise from a positive probabilistic anticipation (i.e., risk) that a legislator or a group of legislators will at some future point make a particular threat to enact adverse legislation.\textsuperscript{201} Hence, anticipated threats can be viewed as premature explicit or implicit legislative threats.\textsuperscript{202}

Conceptually, the notion of anticipatory threats captures a continuum of cases, including instances in which the odds of a future threat are low (e.g., 20\%) as well as instances in which the odds are relatively high (e.g., 80\%). The probability assessment of the underlying risk may vary significantly from one case to another, depending on what information is available.\textsuperscript{203} Among others, factors affecting this assessment include: the legislator’s policy interests; the legislator’s track-record of using threats; and the potential consequences of the conduct in question. In this last case, the magnitude of the conduct’s negative impact on certain social interests provides a proxy for the social visibility of the issue and, thereby for the legislator’s expected interest in issuing a threat to regulate that conduct. Based on this information, firms and other entities anticipating a legislative threat are well-positioned to evaluate the probable content of the potential legislation.

The magnitude of the underlying risk is important in determining the inducement effect of the anticipatory threat. In certain circumstances, anticipatory threats induce entities that anticipate being a target for the threat, to change their conduct and comply with what they believe will be the content of the threat. Such preemptive behavior modifications can lower the risk that a threat of legislation will be issued, therefore reduce the risk of adverse legislation and thus avoiding the negative effect of the threat on firm value and stock returns.\textsuperscript{204}

A clear demonstration of the inducement effect of anticipatory threats, is the case of McDonald’s, when in early 2004 it announced that it had decided to phase out its supersize portions in restaurants operated in the U.S. and U.K.\textsuperscript{205} Giant food portions on the company’s menus, offering up to 50 percent more than a regular portion for just a few cents more, triggered mounting waves of criticism from anti-obesity activists. This, as the debate over health risks of obesity and concerns over the severity of this issue in

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\textsuperscript{201} Analytically, that risk may involve the possibility that the legislator will issue a legislative threat (either an explicit or an implicit threat) as well as the possibility that the legislator will seek to enact adverse legislation without recourse to legislative threats.

\textsuperscript{202} Of course, it is possible that the risk on which an anticipatory threat is based will not materialize and, contrary to expectations, no threat will actually be issued.

\textsuperscript{203} This probability cannot be assessed when no information is available, thus leaving room for speculation and therefore rendering the possibility of a future threat entirely uncertain.


\textsuperscript{205} See Laura Peek et al., McDonald’s Takes Supersize Portions off the Menu, THE TIMES, Mar. 4, 2004. See also David M. Cutler et al., Why Have Americans Become More Obese?, 17 J. ECON. PERS. 93 (2003) (the switch from individual to mass prepared food has lowered the time price of food consumption and led to an increased quantity and variety of consumed foods); Maria L. Loureiro & Rodolfo M. Nayga, International Dimensions of Obesity and Overweight Related Problems: An Economic Perspective, 87 AM. J. AGRI. ECON. 1147 (2005) (identifying factors affecting higher caloric intake in OECD countries).
\end{flushleft}
developed economies gathered pace. The release of the award-winning documentary *Super Size Me* further increased the negative attention on McDonald’s sales practices and the harmful impact on health of its food. Seeking to project a health conscious corporate image and in an attempt to avert the risk of a legislative threat, the company’s decision to alter its product line conveniently came out just as the U.K. government announced a national examination of public health and obesity. Indeed, the McDonald’s case belongs to a sweeping trend among food companies around the world. Worried by a potential threat of adverse legislation, these businesses are encouraging well-being by offering healthier options and providing nutritional information for their products.

### III. THE MECHANISM UNVEILED: HOW DO LEGISLATIVE THREATS REGULATE SOCIAL CONDUCT AND INDUCE SOCIAL CHANGE?

The preceding case studies demonstrate the pervasiveness of legislative threats in the regulatory landscape and offered an analytic classification of threats, pointing, among other distinguishing features, to the legislator’s publicly-made commitment to legislate (explicit threats); to the absence of a publicly-made commitment to pursue a particular reform by means of legislation (implicit threats); and to the risk of a future legislative threat (anticipatory threats).

Whatever threat is being employed, however, casual observations show that legislative threats, including those exerted by a single legislator, can in certain circumstances induce entities to change their behavior and alter their conduct so as to comply with the threat and avert the risk of unfavorable legislation. Understood as

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207 The documentary chronicled the deterioration of the health of Morgan Spurlock, the film-maker, during a month-long experiment during which he ate nothing but McDonald’s food. *See* A. O. Scott, *Film Review: When All Those Big Macs Bite Back, N.Y. Times*, May 7, 2004.

208 Indeed, “the decision to scrap the supersize portion was only taken in order to avoid any threat of legislation which may harm the company.” *See* Kerri Dunne, *Macs Will Not be So Big in Ulster, The Belfast Telegraph Digital*, Mar. 5, 2004, available at http://www.belfasttelegraph.co.uk.

209 The national consultation on public health was announced as a report from more than 100 organizations called for statutory controls to protect children from unhealthy foods. *See* Peek et al., supra note 205.


211 Cases demonstrating the potent inducement effect of legislative threats abound. *See*, e.g., Edwards, supra note 161 (“Past experience tells us that the threat of legislation is the best way to stimulate real improvements and technological innovations”) (internal quotations omitted); Bob McDowall, *UK Banking Competition: The End of the Regulatory Privileges for the Banks?, IT-DIRECTOR.COM*, July 3, 2000, at http://www.it-director.com (“[T]he threat of legislation may be required to elicit changes” that enhance competition in payment systems); *Senate Democrats Back Off Calls for Price Cap Legislation*, supra note 118 (a threat of federal legislation to impose price caps on electricity for the western U.S. induced the Federal Energy Regulatory Commission to extend price mitigation measures for California and ten other states); *News Release: U.S. Businesses Promise Security Plan*
such, legislative threats provide a powerful regulatory mechanism. What is more, the impact of legislative threats on behavior is often socially-superior to that achieved by enforcing formal legislative measures, even before taking into account the saving of significant expenditures of social resources on law enforcement.\textsuperscript{212}

Based on the prevalence of legislative threats, one can assume that legislators derive benefits from exerting threats and, furthermore, that these benefits exceed the costs undertaken by doing so, thus indicating the efficiency and desirability of this strategic choice. The benefits to legislators can take different forms.\textsuperscript{213} While malevolent legislators may benefit from employing threats as a means to extract political rents and secure campaign contributions from special interest groups and political action committees,\textsuperscript{214} benevolent legislators may benefit from using such threats to promote socially-desirable regulatory policies and thus reaping personal rewards.\textsuperscript{215} Advancing such regulatory objectives increases the legislator’s utility inasmuch as it enhances his political reputation; heightens constituents’ satisfaction; makes campaign contributions more probable; and improves the chance of re-election.\textsuperscript{216} In addition, social reward for benevolence may include enhanced political visibility, thus promoting the legislator’s reputational capital.

Whatever the benefits may be, however, no benefit will accrue unless the threat is believed to be credible. In other words, the entities to which the threat is directed are believed to be credible. In other words, the entities to which the threat is directed are

\textit{by March 1, 2004, supra note 124 (“It seems now the threat of legislation has kicked-started” the industry’s effort to develop a cyber security plan); and Digital Rights Management, supra note 192 (“As work on standards progresses, [the legislative] ‘threat’ is receding”).}

\textsuperscript{212} The point here, to which I return in Part III(D), is the following: whereas enforcement of legislation is confined to preventing violation of the statutory requirements, firms’ compliance with legislative threats may result in a more efficient “regulatory” solution than the one that legislator can prescribe in a formal piece of legislation. In other words, in contrast to formal legislation, legislative threats harness the virtues of threat-induced self-regulation. The functional advantages of self-regulation are discussed in Part II(B).

\textsuperscript{213} Cf. David D. Haddock, \textit{Foreseeing Confiscation by the Sovereign: Lessons from the American West}, in Terry L. Anderson & Peter J. Hill (eds.), \textit{The Political Economy of the American West} 129 (1994) (the sovereign’s dilemma arises from his simultaneous power to create new wealth and to transfer wealth both to himself and to social subgroups).

\textsuperscript{214} The ability to extract wealth effectively gives legislators the power (or, perhaps, the property right) to charge individuals and entities for the right to keep the capital they have amassed and the wealth they have produced. \textit{See} McChesney, supra note 196, at 86. Hence, individuals and entities paying rents are essentially compensating the legislator for not exercising his power and for not imposing undesirable costs or expropriating wealth. Paying rents takes many forms, including campaign contributions, speaking and appearance honoraria, and in-kind transfer of benefits. \textit{Id.} at 45-53. \textit{See, e.g.,} Neil A. Lewis, \textit{Medical Industry Showers Congress with Lobby Money}, \textit{N.Y. Times}, Dec. 13, 1993, at A1 (“As Congress prepares to debate drastic changes in the nation’s health care system, its members are receiving vast campaign contributions from the medical industry, an amount apparently unprecedented for a non-election year”). \textit{See also} Franklin G. Mixon et al., \textit{Rent Seeking and Hidden In-Kind Resources Distortion: Some Empirical Evidence}, 78 \textit{Public Choice} 171 (1994) (indirect benefits include trips, fancy meals or golf rounds provided to legislators and their families and staffs).

\textsuperscript{215} Cf. John W. Kingdon, \textit{Congressmen’s Voting Decisions} 248 (1989) (“most members [of Congress] have their conceptions of good public policy, and act partly to carry that conception into being”). \textit{See also} Richard L. Hall, \textit{Participation in Congress} 69 (1996) (legislative activism is related to the belief that liberal members share in federal action as an effective instrument for social betterment).

\textsuperscript{216} Building the legislator’s reputation increases his reputational capital which, in turn, enables the legislator to make believable threats in the future and derive additional benefits.
bound to remain indifferent unless they have reason to believe that (a) the legislator will carry out the threat if they do not comply, and (b) the expected loss from enacting the threatened adverse legislation is greater than the cost of compliance with that threat.

Yet precisely which conditions render threats credible (or incredibl e) and therefore effective (or ineffective), has no straightforward answer. In fact, given the inherent intricacy of the political process, the answer to this question is anything but intuitive. Actually, one’s intuition (and lay experience) leads to the conclusion that threats and promises made by elected representatives are inevitably untrustworthy and therefore can hardly be afforded credibility. Attesting to the perplexing features of the legislative process and consequent uncertainty, Woodrow Wilson correctly observed more than a century ago that “[o]nce begin the dance of legislation, and you must struggle through its mazes as best you can to its breathless end, – if any end there be.”217

The functional question that lies ahead—namely, how do legislative threats induce a change in behavior so as to regulate social conduct?—is central to the theory of legislative threats. The inquiry below attempts to answer precisely this question in order to provide a comprehensive theoretical account of the inducement effect of legislative threats, the elements that contribute to a threat’s effectiveness, and the response of threat-recipients in equilibrium. Disentangling the inducement effect is the key to this theoretical discussion inasmuch as it reveals the factors that determine how effective a threat will be, and therefore allows for a precise prediction of the regulatory impact.

My analysis employs concepts and analytic methods from the field of non-cooperative game theory to account for the strategic interaction between legislators and threat-recipients.218 The theoretical inquiry unfolds in the following manner: Section A models the use of legislative threats as a dynamic, non-cooperative game; and identifies the sine qua non conditions of the threats’ inducement effect on the behavior of threat-recipients. Section B focuses on the credibility of legislative threats and identifies the conditions that make threats credible or incredible. Section C considers the effects on compliance of strategic interaction within organized and non-organized groups. Lastly, Section D examines bargaining in the shadow of legislative threats.

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218 Game theory is the discipline of economics that focuses on the study of strategic interaction between individuals and entities and helps understand and predict their behavior in various social contexts. The theory of games comprises the distinct fields of non-cooperative and cooperative game-theory. Non-cooperative strategic behavior encompasses actions that are designed to improve utility for one player while reducing utility for the other; in contrast, cooperative games includes behaviors that increase (or decrease) the utility of all players. Individuals in non-cooperative games may take actions that, in common parlance, would be labeled “cooperative,” although such an action is taken because it is in the best interest of each player, for example, due to fear of retaliation. For a non-formulaic primer on non-cooperative game theory see David M. Kreps, Game Theory and Economic Modelling 9-36 (1990). A more technical presentation of this subject is found in Roger B. Myerson, Game Theory: Analysis of Conflict 1-31 (1991).
A. A Game-theoretic Model of Legislative Threats

How and in what circumstances do legislative threats induce threat-recipients to change their conduct so as to align it with the legislative demands as outlined in the threat? In other words, when are firms expected to comply and when is compliance unlikely? In order to begin analyzing these issues, it is necessary to consider the use of legislative threats as a form of strategic interaction, by modeling threats to legislate as a non-cooperative game in which legislators and firms interact.\(^{219}\) In the game, the predicted actions for each of the players constitute the equilibrium. As in models of strategic behavior, the strategy a player employs in equilibrium, crucially depends on what one player believes another player will do in a particular situation.

My discussion begins with constructing a model that: (i) accurately outlines the rules of the game (i.e., how it’s played and who plays when); (ii) describes the game’s information structure (i.e., who knows what and when); and (iii) explicitly states the underlying assumptions (i.e., what are the players’ preferences and what do they care about). I begin the analysis with the consideration of a simple game, in which the severity of the threatened legislation is fixed and known. I subsequently extend the theoretical analysis to consider more complex strategic situations in which the legislator can choose (i) the severity of the threatened legislation (i.e., lenient, moderate, and severe), and (ii) whether or not to disclose that severity to the firm, distinguishing between games of perfect and imperfect information, respectively.\(^{220}\)

1. The Rules of the Game

At the outset of the game, the legislator (e.g., a single legislator, a group of legislators, or the government as a whole)\(^ {221}\) issues a threat to enact legislation that will adversely affect a firm if it fails to change its conduct based on the legislator’s demands.\(^ {222}\) Implicitly coupled with the threat is the legislator’s inverse promise that if the firm complies, he will forego seeking to enact the threatened legislation. The model

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\(^{219}\) A strategic game consists of a list of participants (i.e., players); an array of possible actions for each player (i.e., strategies); and rewards or losses for those actions for each player (i.e., payoffs). See Avinash Dixit & Susan Skeath, Games of Strategy 24-27 (1999) (defining strategies and payoffs).

\(^{220}\) The analysis of these more complex games is presented in Section 6 below.

\(^{221}\) For simplicity purposes, I do not distinguish between threats issued by one legislator; those issued by a group of legislators acting together through a congressional committee or otherwise; and threats issued by the government as a whole. In fact, assuming all else remains equal, whether the threat is made by one legislator or, rather, by a group has no bearing on the model’s predictions.

\(^{222}\) Presently, the model focuses on a single threat-recipient though, in real life, this is not typically the case except, for example, where a legislative threat is directed to an administrative agency or a mega-firm that dominates the relevant market. See, e.g., Senate Democrats Back off Calls for Price Cap Legislation, supra note 118; see also Puzzanghera, supra note 166 (warning the baseball commissioner that legislation would be imposed unless use of steroids stopped). Section C below extends the analysis to more common scenarios where threats are directed to numerous firms and organizations in an industrial sector or profession. See, e.g., Markhoff, supra note 120 (describing a threat that was directed to 350 computer executives and software developers).

\(^{223}\) Legislators often set compliance deadlines and articulate implementation procedures that firms must follow. See, e.g., Legislation Threat to Banks’ Self-Regulation, supra note 152 (the U.K. government specified implementation procedures in the legislative threat it had directed to banks).
assumes that the severity of the threatened legislation is fixed, such that the legislator cannot opt to threaten the firm with a stricter or more lenient legislation.

If enacted, the threatened legislation will negatively weigh on a firm in direct proportion to the severity of the terms and requirements. For example, the legislation may impose stricter standards on conduct; increase the probability of enforcement actions for violations of already existing laws (e.g., by providing individuals strong incentives to bring suits); or raise fines and potential damages, which also make law enforcement incentives stronger. Thus, the negative impact on utility can take many different forms, such as: reducing or capping the prices of the firm’s products; revoking business licenses and barring specific business practices; imposing measures that augment operational and regulatory costs; increasing liability exposure and liability risks; and enhancing competition in the market in which the firm operates.

Next, the firm decides whether to conform to the legislator’s demands or, rather, to not respond so that the firm continues engaging in the same course of conduct. Although the firm can decide to comply or not, it does have the ability to decide the extent to which it complies (i.e., compliance is indivisible).

The legislator then makes a choice between carrying out the threat so as to enact the legislation or not following through with the threat. Yet, the legislator’s decision to carry out the threat does not necessarily mean that he will be successful in passing the threatened legislation; rather, all it means is that the legislator will endeavor to enact the threatened legislation to the best of his ability. In other words, implementing the threat is tantamount to creating a risk (but definitely not certainty) that the adverse legislation will be enacted into law. This feature of legislative threats reflects the inherent uncertainty of the legislative enterprise. I postpone discussion of this feature until Section 5, where I will re-introduce this issue in order to refine the model’s predictions.

In sum, the strategic interaction between legislators and firms is a dynamic, non-cooperative game in which players adhere to a strict order of play.

2. The Information Structure of the Game

The key questions in strategic games is how much information does each player know, and when does he know it. The information structure of a game depends on

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224 For example, the threatened legislator may appropriate public resources for enforcement of existing laws. Likewise, the threatened legislation may create powerful private incentives to enforce the law on targeted firms, thus subjecting these firms to greater liability exposure and higher liability risks.

225 As I show in Section D, the firm may either strictly comply with the legislator’s demands or commence regulatory bargaining in the shadow of the threat in an attempt to reach a mutually-agreeable solution.

226 While the firm can determine the magnitude of resources it will invest in compliance, what matters is not how much effort it made but, rather, whether or not it complied with the legislator’s demands. Of course (though this is not the case presently under discussion), the legislator may choose to create an inverse link between the severity of the threatened legislation and the degree of observable compliance, thus making the expected negative impact of the threat contingent upon the level of compliance.

227 This type of threat, known as a probabilistic threat, is observed for example in the public international relations scene, in which governments make threats that involve the infliction of economic or other harm with some probability, but not with certainty. See Dixit & Skeath, supra note 219, at 302.

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what information is available to players, when it is their turn, at various junctures throughout the game. This structure is important because the strategy a player uses in equilibrium crucially depends on what one player thinks the other player knows in the particular situation.

The present model describes a game with perfect information.228 Perfect information refers to the idea that a player knows whose turn it is as well as the exact position the game has reached in the game tree.229 In the context of this game, a firm can tell both that a legislator has issued a threat and what the severity of the threatened legislation is. For this very reason, the game also qualifies as one with symmetric information.230

Even though the legislator can tell whether or not the firm has complied with the demands articulated,231 he cannot directly observe the various measures taken by the firm in order to ensure compliance (e.g., internal controls, risk-reduction measures). Here, the underlying intuition is twofold: first, the legislator can monitor the firm’s processes and output for compliance using, among other things, testing, auditing,232 and agents to gather necessary information;233 second, the firm normally has a strong incentive to divulge information exhibiting its compliance.

3. The Game’s underlying Assumptions

This theoretical model rests upon several intuitive and realistic assumptions, which ought to be stated explicitly.

(a) Players’ Rationality

It is assumed that players are fully knowledgeable about the structure and rules of the game; they are rational, meaning that they both seek to maximize a predetermined

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228 Ordinarily, the information available to players in the game can be categorized in four ways: whether it is, (i) a certain or uncertain game; (ii) a game with perfect or imperfect information; (iii) a game with symmetric or asymmetric information; or (iv) a game with complete or incomplete information. A detailed explanation of these categories is found in Eric Rasmusen, Games & Information 47-51 (3rd ed. 2001).

229 Technically, in a game of perfect information (e.g., chess), each information set is a singleton; otherwise, the game is one of imperfect information. Id. at 47-48.

230 A game is one of symmetric information if one player has the same information that the other player has. Id. at 49-50. In the present game, the legislator and the firm hold the same information. In keeping, I make the realistic assumption that the legislator and the firm hold equal information (or, albeit, equal access to information) that pertains to the probability that the threatened legislation will pass congressional muster. Hence, both players are equally well-positioned to assess the probability that the bill will be enacted into law.

231 A more complicated scenario is one in which the legislator cannot tell with certainty whether or not the firm has complied. Introducing this uncertainty into the model clearly increases the analytic complexity while offering no added value. In any case, assuming such uncertainty exists and further that the firm complies, the firm is expected to increase its investment in complying in order to reduce the risk that the legislator will carry out his threat (due to an error in monitoring compliance which works to the detriment of the firm). Intuitively, this conclusion assumes that the higher the investment in compliance, the lower is the risk of error.

232 For example, the legislator can check whether firms have reduced gas emissions, tested baseball athletes for steroid use, or monitored digital obscenity in films. That being said, more often the legislator is unable to directly observe what measures the firm has undertaken to ensure compliance with the legislator’s demands.

233 See, e.g., Monitoring Proforma for Commercial Leases Code of Practice, supra note 165 (in accordance with the threat, the government appointed various bodies to monitor implementation in the property sector).
utility measure;\textsuperscript{234} and they are aware of each others’ rationality. In other words, rationality is common knowledge amongst the players such that they are both aware that the other is also seeking to maximize utility.\textsuperscript{235}

(b) The Legislator’s Utility

Consistent with public choice theory,\textsuperscript{236} a legislator’s utility increases both with his success in advancing socially-desirable policies and with solidifying his political reputation (\textit{e.g.}, for toughness, fairness, and policy stance).\textsuperscript{237} However, investment of time and other resources in a complex and protracted legislative process decreases the legislator’s utility, insofar as it reduces the time and resources available for the time-intensive activity of fundraising.\textsuperscript{238} Furthermore, as evidenced by empirical research in political economy, it is assumed that constituents and political contributors reward efforts to advance beneficial policies and good reputation, and penalize failures and poor reputation. This, then, has the effect of either enhancing or degrading a legislator’s reputational capital.\textsuperscript{239}

(c) The Firm’s Utility

Another foundational assumption of this model is that a firm’s utility improves with net expected profits and recedes with the rise of systematic risks (\textit{i.e.}, risks that

\textsuperscript{234} More specifically, what this assumption means is that every player maximizes perfectly and completely against the strategies of his opponents; that the character of those opponents and of their strategies are perfectly known (\textit{and}, where not, that the uncertainty in that respect is understood and accounted for); and that players are able to evaluate all their options. \textit{See} Kreps, supra note 218, at 139. Admittedly, however, individual behavior is often boundedly rational (\textit{i.e.}, intendedly rational, but only limitedly so) or wholly irrational. \textit{See} Herbert Simon, \textit{Rationality in Psychology and Economics}, 59 J. BUSINESS 209 (1986). For a general review see Richard A. Posner, \textit{Behavioral Law and Economics}, in \textit{FRONTIERS OF LEGAL THEORY} 252 (2001). Game-theorists have developed different research strategies to capture notions of bounded rationality in strategic behavior. \textit{See} Kreps, supra note 218, at 154-56.

\textsuperscript{235} In other words, I assume that there is complete information as to the structure of the game, the players’ rational decision-making, and the player’s respective objectives.

\textsuperscript{236} As a general matter, legislators conduct their political business so as to advance political self-interest. \textit{See} Lemieux, supra note 113, at 22 (arguing that when acting as voters, politicians, or bureaucrats, individuals continue to be self-interested and try to maximize their utility).

\textsuperscript{237} \textit{See} Kroszner & Stratmann, \textit{Interest Group Competition and the Organization of Congress}, supra note 194; \textit{see also} Kroszner & Stratmann, \textit{Congressional Committees as Reputation-building Mechanisms}, supra note 195.

\textsuperscript{238} \textit{See} Neustadt, \textit{Foreword to the 2001 Edition}, in Redman, supra note 112, at 8-10.

\textsuperscript{239} \textit{See} Randall S. Kroszner & Thomas Stratmann, \textit{Corporate Campaign Contributions, Repeat Giving, and the Rewards to Legislator Reputation}, 48 J. L. & ECON. 41 (2005) (using data on political contributions to members of the House of Representatives during seven electoral cycles from 1983/84 to 1995/96 and finding that greater reputational development is rewarded with greater political contributions). Notably, using votes and contributions to reward legislators for good reputation may reflect constituents’ strategic and non-strategic preferences for good political reputation. The strategic derivation of this preference is attributed to some form of herding behavior, namely, that voters exhibit a preference for good reputation because they believe that others prefer good reputation too (perhaps as a result of a non-strategic preference) and, therefore, assuming all else remains equal, reputable legislators have higher chance of re-election. Lastly, fellow lawmakers may also reward good reputation (\textit{e.g.}, higher cooperation) and penalize bad reputation (\textit{e.g.}, political backlash). Hence, legislative threats and promises are not cost-free.
cannot be diversified away including, in particular, the risk of harmful legislation). The execution of a threat by a legislator decreases the firm’s utility in two ways: (i) it reduces expected profitability and firm value, thus negatively affecting the firm’s stock returns and (ii) it increases the systematic risk to which the firm is exposed (i.e., the risk of adverse legislation), thus diminishing firm value even further.

Furthermore, self-regulatory organizations established by law (e.g., NASD) and privately-ordered groups (e.g., NYC diamond dealers), are bound to experience an additional decline in utility. This, because the threatened legislation may abolish or otherwise intrude upon their valuable self-regulatory privileges or limit their capacity to self-govern by private ordering. The negative impact on utility in this context is threefold: (i) the threatened legislation may introduce inefficient standards and requirements (compared with those the firm may devise through threat-induced self-regulation); (ii) the threatened legislation may instate sweeping regulatory reforms, going beyond what is necessary to address the issue in question (i.e., a spillover effect); and (iii) the legislative intrusion may set a precedent, thus making additional regulatory intervention in the future more likely (i.e., a regulatory avalanche).

(d) The Superiority of Self-regulation
Assuming that they adequately account for the potential externalities of their conduct, firms are best-situated to regulate themselves. This is due to information

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240 Depending on firm-specific characteristics, systematic risks affect all projects a firm engages in. Hence, macroeconomic risks, including interest rate and regulatory changes, qualify as prime systematic risks. Systematic risks are particularly undesirable because, unlike non-systematic or idiosyncratic risks, they cannot be reduced by diversification. The firm therefore cannot guard against this risk by choosing different projects. See “Systematic risk,” in Black, supra note 50, at 455. While greater certainty about the future facilitates private planning and investment, systematic regulatory risks inhibit investment and reduce economic growth. See Christian Gollier, The Economics of Risk and Time 32-34 (2001).

241 An event study using a sample of Canadian firms has shown that the announcement of potential adverse legislation negatively affects the stock prices of firms covered by that legislation. See Beck et al., supra note 204.

242 Research in corporate finance documents the “Congressional Effect,” showing that stock returns are lower and stock price volatility is higher when Congress is in session. This is consistent with the hypothesis that firms face a more uncertain regulatory environment when legislative activity is under way. See Michael F. Ferguson & Hugh D. White, Congress and the Stock Market (2005), at www.ssrn.com (strong link between Congressional activity and stock market returns, consistent with the hypothesis that investors evaluate Congressional activity over time and adjust their expectations accordingly).

243 For a detailed discussion of the NASD’s statutory self-regulatory status see Section I(B) above.

244 For a discussion of private ordering in the New York diamond industry see Section I(D) above.

245 The U.K. government’s plan to introduce anti-money laundering legislation not only threatened to introduce adverse legislation but also to bring to an end the long-standing tradition of self-regulation in the banking and financial sectors. See Legislation Threat to Banks’ Self-Regulation, supra note 152 (describing the implications of the U.K. government’s anti-money laundering legislative threat). Indeed, the risk of abolishing the self-regulatory legal status of financial institutions and, as a corollary, the potential for more regulatory intervention, intensified the industry’s concern over the government’s threatened legislation and the negative effects of high compliance costs that the financial institutions would have to incur.

246 Cf. Jonathan Prynn, Lloyd’s Facing New Legal Controls, The TIMES, June 4, 1993 (“Lloyd’s of London has until the end of the year to sort out its problems before facing legislation to end its jealously guarded self-regulatory status … [and] be brought within the City’s regulatory mainstream”).

247 The “uncertainties embedded in the regulatory process, and the assumptions the regulators must make in
asymmetries between legislators and firms with respect to the nature of the targeted conduct (e.g., the scope of the problem, the sources of the problem, and possible solutions); the significant cost of obtaining such information; and differences in the institutional capacity and availability of resources necessary to devise cost-effective regulatory measures. In other words, compared with legislators and regulators, firms incur lower transaction costs in discovering the correlation between processes and outputs. Thus, firms are better-positioned to design cost-effective solutions and socially-desirable policies for dealing with the very same concerns that legislators seek to address through legislation. Hence, threat-induced self-regulation offers a superior cost-effective method to achieving the regulatory objectives aimed at by the threatened legislation.

(e) The Repeated Nature of the Game

A final assumption is that both legislators and firms are repeat players in such a game, though not necessarily against each other. Legislators and firms often make similar decisions in strategic environments in which the rules of the game remain virtually unchanged. The only variable, however, is each player’s “history,” which grows as time passes. Hence, both players are cognizant of (and, indeed care about) the fact that any move made in one game shapes their reputation and may have repercussions in future games. We therefore observe two-sided reputation-building.

4. Extensive Form Representation of the Game

Figure 1, shown below, represents the legislative threat game in what is known in order to arrive at recommendations for actions despite those uncertainties render the process of risk regulation totally ineffective and therefore inefficient. See Breyer, Breaking the Vicious Circle, supra note 118, at 42-50. In addition, problems emanating from tunnel vision, random agenda selection, and the use of inconsistent risk-assessment methods render legislators virtually incapable of devising effective measures of risk regulation. Id. at 10-29.

248 Members of Congress are typically thrust unprepared into a specialized milieu and confronted with a massive volume of highly technical legislation, with most of which they can deal only superficially. See Raymond A. Bauer et al., American Business and Public Policy 408-413 (1968). Likewise, committee members are often rarely present or disinterested. See Lynette Perkins, Influences of Members’ Goals on their Committee Behavior: The U.S. House Judiciary Committee, 5 LEGIS. STUD. Q. 373, 378-79 (1980) (two-thirds of the House Judiciary Committee members hardly participated in the committee’s regular work and deliberations).

249 For a discussion of the functional advantages of self-regulation see Part I(B) above.

250 While the legislator’s term in office places a limit on the number of possible repetitions of the game, a firm can repeat the game an infinite number of times because, at least in theory, a firm can exist forever. Hence, it is a finitely repeated game for the legislator but an infinitely repeated game for the firm. See Rasmusen, supra note 228, at 109-117. This asymmetry is of no immediate consequence except for the fact that whether a game is finitely- or infinitely-repeated bears impact on the players’ behavior during the final game.

251 Indeed, zero-sum one-shot games can turn into win-win games if continued in the long-run. See Dixit & Skeath, supra note 219, at 20-21, 257-66 (discussing one-shot, finitely-repeated, and infinitely-repeated Prisoner’s Dilemma games). See also Glenn Ellison, Cooperation in the Prisoner’s Dilemma with Anonymous Random Matching, 61 REV. ECON. STUD. 567 (1994) (despite the inability to tell who one’s opponent is in large populations, players in repeated Prisoner’s Dilemmas cooperate).
technical jargon as an extensive form game (i.e., a “game tree”). I present the game in extensive form because the strategic form does not depict the information structure of the game, namely—what information every player knows at each juncture. The game tree is read left to right, beginning at the initial node and branching out until the game concludes and the players’ respective payoffs have been determined. Figure 1 reveals the timing of each player’s move, and the information each player has when it is his turn to take action. Each node represents a “position” in the game, a point at which a player must choose and play a strategy. The arrows originating from each node signify the available strategies to the player as a given moment in the game.

Any pair of numbers shown in parentheses near the arrows represents the end of the game and the payoffs (i.e., the utility gains or losses) for each player. In each pair, the legislator’s payoff appears first followed by the payoff for the firm. These payoffs embody how players evaluate possible outcomes in the game: they reflect any gain or loss that the players consider relevant, whether pecuniary or not. The firm’s payoff reflects both the cost of compliance with the legislative threat (if the firm actually complies), and the negative impact of the threatened legislation (if and when the threatened bill is enacted). The legislator’s payoff reflects the cost incurred by pursuing the threatened legislation and the benefits received if he is successful in inducing the desired change in behavior. By issuing the threat and through congressional and public appearances, the legislator ties himself to the legislative threat and claims credit for a possible policy change. And, by associating himself with the threatened legislation (e.g., by adding his name to the bill), the legislator may guarantee that if the threat is exercised and the bill is enacted into law, any benefits that may accrue will be internalized.

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252 There are two basic forms that are used to present non-cooperative games: the first and more simple is the strategic form (or normal form), which consists of a matrix of payoffs and strategy profiles; the second and more complex is the extensive form, which is presented as a tree of possible strategies and their corresponding payoffs. See Fernando Vega-Redondo, Economics and the Theory of Games 4-16 (2003) (discussing differences between extensive and strategic form models).

253 The first position in the game (in this case, the issuance of the legislative threat) is depicted by an open dot; the other dots represent subsequent positions and are filled in.

254 For a discussion of the concept of payoffs see Vega-Redondo, supra note 252, at 7-8.

255 The cost of compliance is fixed at 5. It is assumed that in order to comply, the firm must incur some fixed costs (e.g., installing a new technology), the magnitude of which does do not change across firms (i.e., installing the technology costs the same irrespective of firm-specific characteristics). In addition, compliance has a binary property, such that the firm can comply or not comply but not determine to what extent to comply. If, however, there is a chance that a legislator could not tell whether or not the firm complies, the firm may increase its investment in order to reduce the risk of error and the ensuing risk of the threatened legislation.

256 I assume that the negative impact of the threatened legislation is 20. Generally, this cost reflects expenditures that the firm must incur and the resources it must invest in order to comply with the new legislation (e.g., switching costs from one regime to another, such as investment in new systems).

257 I assume that the cost of drafting, introducing, and enacting the threatened legislation is 5.

258 I assume that the benefit from inducing the firm (and, as we will see later, the entire industrial sector) to change its undesirable conduct is 5.

259 This is a rather common legislative practice, of which the Sarbanes-Oxley Act of 2002 is one example.
5. **Equilibrium Analysis: How are Players Expected to Behave?**

Having modeled the strategic exertion of legislative threats as a dynamic, non-cooperative game, I now turn to examine how the players are expected to behave in this strategic interaction. Herein, two questions merit thorough examination. First, are firms expected to respond to the legislative threat and comply with the legislator’s demands or, rather, to remain indifferent? Furthermore, which conditions trigger compliance or non-compliance? Second, are legislators expected to carry out the threat and seek enactment of the threatened legislation if firms do not comply or, rather, to retract the threat? And, under which conditions will they enact or retract? The predictions concerning the players’ behavior express the ability of legislative threats to induce a change in conduct and, more generally, demonstrate their functioning as regulators of social conduct.

Game-theoretic methods and, in particular, the Nash equilibrium solution concept, can be used to generate conjectures as to how players are anticipated to act. The prediction of what will ensue in equilibrium is often referred to as the game’s “solution.” In essence, the Nash equilibrium concept postulates that the equilibrium of a game consists of an array of strategies, one for each player, such that each player’s...
equilibrium strategy is his best response (in the utility-maximizing sense) given the supposed strategy of the other player (who, also, plays the strategy that is his best response). Thus, provided that players actually employ their Nash equilibrium strategies, no player has any incentive (in the sense of seeking to improve his own payoff) to deviate from his equilibrium strategy because he would not be better-off choosing a different strategy. The intuition driving this analysis provides that if a mode of behavior is self-evident, and each player believes it is self-evident (and if each player believes that the other player believes it is self-evident, and so on), then each player must be choosing a strategy that is his best response to what the other player is evidently doing. This logic is precisely what underlies the Nash equilibrium concept.

How, then, does a firm determine what its best response is, once a legislator has threatened to enact unfavorable legislation? Quite simply, the firm compares the costs and benefits of playing a given strategy. Seeking to maximize utility (that is, by increasing expected net profits and reducing systematic risks), the firm will choose the strategy that maximizes its benefits and minimizes its costs. This, by definition, is the firm’s optimal, or best response, strategy. Most importantly, what is optimal for the firm actually depends on what the legislator is expected to do. The firm’s best response (i.e., comply or not comply) therefore is contingent upon the firm’s belief whether or not the legislator will carry out the threat if the firm fails to comply. In keeping, this response also relies on its belief whether or not the legislator will keep the implicit promise to forego enacting the threatened legislation if the firm does comply. In other words, the firm’s optimal strategy depends on whether the legislator’s threat (as well as the accompanying implicit promise) is credible or, rather, incredible (i.e., an empty threat or an empty promise).

The legislator’s threat is incredible if it is expected that when called upon, the legislator will not exercise the threat (irrespective of whether or not the firm complies), thereby just making “cheap talk.” Clearly, the firm’s best response in this case is the “don’t comply” strategy because, compared with the payoff for playing the “comply” strategy, this one maximizes the firm’s utility. Stated differently, it makes no sense to incur the cost of compliance when the threat is incredible, because doing so would not improve the firm’s position. Either way, the risk of adverse legislation is zero. Moreover, once a strategy has been chosen, there is no incentive to depart from it and choose another strategy, thus satisfying the Nash criterion mentioned above. This analysis generates the game’s incredible threat equilibrium in which the firm does not comply and the legislator does not carry out the threat.

Conversely, a threat is credible when a legislator finds that it is in his best interest (in the utility-maximizing sense) to carry out the threat if the triggering event occurs.
Similarly, a legislator’s promise is credible if it is in his best interest to keep his promise and abstain from instituting the threatened legislation if the firm complies. In other words, in the presence of credibility, the legislator will carry out the threat if the firm fails to comply but keep his promise to avoid enacting the threatened legislation if the firm does comply. Clearly, credibility alters the scene dramatically. The firm’s best response in this case is the “comply” strategy, which maximizes the firm’s utility insomuch as it spends relatively little on complying and thus avoids altogether the risk and cost of unfavorable legislation. This is the case because once the firm chooses to adhere to the legislator’s demands, the legislator’s best response is to do refrain from realizing the threat. In contrast, were the firm to have chosen “don’t comply,” it would have saved the cost of compliance but, at the same time, would have been subject to the undesirable risk and expense of adverse legislation. Hence, provided that the legislative threat is credible, it induces compliance with the legislator’s demands and as a result avoids the need for enacting harmful legislation. This analysis produces the game’s credible threat equilibrium, in which the firm complies and the legislator does not carry out the threat.

In sum, a Nash equilibrium analysis derives two mutually-exclusive solutions: the credible threat equilibrium and the incredible threat equilibrium. Practically, these solutions suggest that players can play the game by selecting either of two sets of strategies depending on the credibility of the threat. In other words, which of these predictions will actually materialize depends on whether the legislative threat (and the accompanying implicit promise) is credible or, rather, incredible. In the incredible threat equilibrium, the firm does not comply with the legislator’s demands and the legislator does not carry out the threat. In direct contrast, in the credible threat equilibrium the firm complies with the legislator’s demands and thus the legislator does not carry out the threat.

6. Refining the Predictions: Incorporating Probabilistic Threats

The aforementioned predictions merit further consideration so as to adequately examine the unique properties of legislative threats. The characteristic feature of the legislative threat derives from the fact that executing the threat does not—and, in fact, cannot—ensure the enactment of the threatened legislation. The legislator cannot guarantee that the threatened consequences will actually materialize. Rather, carrying out the threat to legislate simply means that the legislator will endeavor to enact the

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264 A numerical example based on Figure 1 demonstrates the following point: if the threat is credible, it makes perfect sense to “comply” and obtain a payoff of -5 rather than “don’t comply,” in which case the payoff is -20. Hence, compliance is the firm’s best-response because it ensures that the firm’s total utility loss will be limited to 5, whereas non-compliance would have resulted in a total utility loss of 20.

265 Technically, the credibility of the legislator’s threat can shift the solution of the game from the non-compliance equilibrium to the superior, utility-maximizing compliance equilibrium.

266 That, of course, would have become possible if transacting in the political market was cost-free. In other words, the legislator would have been able to garner sufficient political support to enact the threatened legislation if he could engage in Coasian bargaining over policy. Cf. Francesco Parisi, The Political Coase Theorem, 115 PUBLIC CHOICE 1 (2003) (considering the applicability of the Coase theorem to political markets).
threatened legislation. In other words, attempting to achieve something does not ensure that the desired outcome is achieved, especially if it is contingent upon factors other than one’s effort. Therefore, the threatened legislation is probable but not certain.

In game-theoretic parlance, legislative threats qualify as probabilistic threats, threats that create a risk but not a certainty of a dire outcome.\(^{267}\) Upon further examination of the concept of legislative threats, it becomes discernible that the underlying mechanism is more subtle than previously suggested: carrying out the threat exposes the firm to the risk—but not certainty—that the threatened legislation will be enacted into law. Surely, the probabilistic nature of legislative threats is due to the inherent uncertainty of the political enterprise that governs the legislative process.\(^{268}\)

The probabilistic feature of legislative threats requires a refinement of the predictions that constitute the credible threat equilibrium, in which the firm complies with the legislator’s demands and the legislator avoids carrying out the threat. Incorporating the threat’s probabilistic property into the analysis, compliance may or may not be the firm’s best response. In each case, this depends on the probability that the threatened legislation will be successfully enacted into law. More specifically, assuming the threat is credible, a cost benefit analysis indicates that compliance will be the firm’s best response only insofar as the expected ex post negative impact of the threatened legislation (which is equal to the loss in utility multiplied by the probability of that loss) exceeds the cost of ex ante compliance with the legislator’s demands.

In other words, the firm’s cost-benefit analysis takes into account the following variables: (i) the probability of the threatened legislation; (ii) the cost of ex ante compliance with the legislator’s demands; and (iii) the ex post adverse impact of the threatened legislation on utility (that is, if it is actually implemented in its originally-contemplated form). Mindful of the fact that enacting the threatened legislation into law is by no means certain, the firm’s choice of best response strategy is driven by the probability-discounted, negative consequences on utility.\(^{269}\)

The present refinement shows that the inducement effect of legislative threats on the behavior of a firm is qualified by an effectiveness condition. That is, a threshold

\(^{267}\) See Dixit & Skeath, supra note 219, at 302, 451-54 (examining and modeling probabilistic threats).

\(^{268}\) The legislative drama covers a wide variety of activities that legislators use to influence the ultimate legislative product and get different interests represented. Among others, these include behind-the-scenes negotiations, planning party voting strategy, negotiating with the administration, soliciting proxies, lobbying other committee members, or negotiating amendments with outside groups. See Hall, supra note 215, at 41-44. Clearly, this renders the legislative process and its end product all the more uncertain.

\(^{269}\) A numerical example demonstrates this point. The firm incurs a cost of 5 to comply with the legislator’s demands, but if the firm does not comply and the threatened legislation is enacted, the firm will suffer a definite loss of 20. Yet, if there is some chance that the legislator will not succeed in enacting the threatened legislation, the expected loss will be proportionately lower than 20. In these conditions, it makes utility sense to “comply” only if the probability that the threatened legislation will be enacted into law is equal to or greater than 25%. The logic here is that risk exposure decreases the firm’s utility and, hence, the firm will comply even if only to avoid the 25% risk of adverse legislation. Cf. Ferguson & White, supra note 242 (legislative activity in Congress is correlated with lower stock returns, consistent with the hypothesis that higher regulatory uncertainty reduces firm value). In all other cases, it makes sense to do nothing because the expected loss is lower than the cost of compliance.
probability below which a firm will not comply with the legislator’s demands given the cost of compliance and the harmful burden of the threatened legislation, even though the threat is (or merely believed to be) credible. It can be concluded that credibility is a necessary albeit insufficient condition for inducing a firm’s compliance in equilibrium. In other words, compliance with a legislator’s demands depends on the fulfillment of two conditions: (i) the threat must be credible; and (ii) the probability that the threatened legislation will be passed into law must exceed the effectiveness condition. Unless both these conditions are strictly met, the firm will do nothing to comply and so the legislator will be called to carry out the threat.

Clarifying the predictions that constitute the credible threat equilibrium, the present analysis offers two mutually-exclusive predictions. First, when the probability that the threatened legislation will be enacted into law exceeds the effectiveness condition, the firm complies with the legislator’s demands and the legislator avoids enacting the legislation (i.e., credible threat compliance equilibrium). Second, when the probability falls below the effectiveness condition, the firm does not comply and the legislator carries out the threat to enact the legislation (i.e., credible threat non-compliance equilibrium).

As one would expect, however, the probability that the threatened legislation will be enacted into law may change from case to another. It is therefore prudent for a firm to assess this probability so as to choose its best response wisely. To that end, a firm can gather and analyze relevant data to gauge the likelihood of both favorable and unfavorable voting scenarios in the House and Senate.

Inevitably, given the inherent intricacy of policy-making processes, a variety of institutional, political, and reputational factors may influence legislative behavior in Congress and therefore the likelihood of the threatened legislation. The composition of the House and Senate, for example, is a significant determinant. In addition, the membership and control of the relevant congressional committee is an overwhelmingly important factor that can make or break the threatened legislation. Likewise, differences in partisan preferences concerning the threatened legislation’s policy are also important. Lastly, to the extent that it is observable to someone outside the political arena, logrolling (i.e., vote-exchange agreements) can also shape the firm’s probability assessment and, hence, its best response.

Co-sponsorship—which has been aptly dubbed “one of the lubricants of the

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270 While credibility and probability are analytically distinct concepts, a threat’s credibility may affect the probability of the threatened legislation, and vice versa. Here, the intuition is that the higher the stakes for the legislator in carrying out the threat (e.g., higher potential to damage reputation), the more inclined he will be to work to increase the chance of success of the legislation.

271 Cf. John Boyce & Diane Bischak, The Role of Political Parties in the Organization of Congress, 18 J. L. ECON. & ORG. 1 (2002) (parties appoint members to committees, taking into account how the committees’ membership affects the legislation adopted by the legislature). Moreover, committees characteristics are an especially important factor because, given their institutional design and agenda-setting mandate, committees are able to enforce their policy wishes not only because they originate bills but also because they get a second chance to shape the proposed bill after their chamber has worked its will. See Kenneth J. Shepsle & Barry R. Weingast, Institutional Foundations of Committee Power, 81 AM. POLIT. SCI. REV. 85 (1987).

272 See David Epstein, Partisan and Bipartisan Signaling in Congress, 14 J. L. ECON. & ORG. (1998) (when partisan differences over policy are small, bipartisanship is preferred to partisan policy making).
legislative process”—is another factor likely to increase the probability of the threatened legislation. A solicitation for co-sponsorship carries an implicit offer that in return for the co-sponsor’s support of the bill, the soliciting legislator will give the co-sponsor an opportunity to be associated with the bill and thereby share the much-needed political credit and publicity. As a result, co-sponsorship provides a medium for political exchange, which enables a legislator to guarantee sufficient support of the threatened legislation.

Clearly, these factors are but a few of the more obvious considerations that bear on the probability of the threatened legislation. Furthermore, political reputation and established track-record of other legislators; legislators’ social group identification; special interests and potential legislative capture; the extent to which one’s party controls individual legislators’ voting; the public opinion on the issue in question and its impact on policy-making circles; and whether the threat is explicit, implicit, or anticipatory may also play a significant role.

A legislator is rationally interested in securing the firm’s compliance so as to avoid incurring the cost of carrying out the threat. The compliance equilibrium maximizes a legislator’s utility and makes him better-off. However, to ensure that this equilibrium transpires, the legislator must guarantee that compliance is the firm’s best response. Practically, the legislator may do one or all three of the following: (i) lower compliance costs; (ii) make the legislation’s adverse impact harsher; or (iii) strive to render the probability of the threatened legislation greater than (or at least equal to) the effectiveness condition.

Lowering the cost of compliance, which essentially requires that the legislator relaxes her demands, is undesirable from a utility-maximization perspective. On the other hand, increasing the severity of the threatened legislation and intensifying its

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273 See Redman, supra note 112, at 78.
274 Id. at 79.
276 For example, research shows, though not without controversy, that legislators’ policy interests and the intensity of their revealed preferences are related to their personal identification with particular social groups, defined by race, ethnicity, gender, and age. See Hall, supra note 215, at 70-71, 190-194.
277 Cf. Greg Winter, House G.O.P. to Drop Idea of Penalty for Steep Rises in Tuition, N.Y. TIMES, Mar. 3, 2004, at A14 (the threatened “legislation has been an ever-present part of the debate over the affordability of college since [Representative McKeon] put forward the idea a year ago”).
278 Here, the implicit assumption is that carrying out the threat if and when called upon to do so is in the legislator’s best interest, thus ensuring the threat’s ex ante credibility.
279 Figure 1 shows that whereas the payoff for carrying out the threat is (-5), the payoff the legislator receives if the firm does comply is 5. Compliance therefore increases the legislator’s utility by 10 units.
280 Technically, the legislator must ensure that the ex post probability-discounted negative effect of the legislation is greater or equal to the ex ante cost of compliance.
281 A partial relief for a firm from the demands to change its undesirable conduct is bound to reduce a legislator’s benefits from inducing a desired social change.
282 Severity level encompasses any aspect of the threatened legislation that influences the magnitude of the negative consequences experienced by the firm. Hence, stricter standards of conduct, higher penalties for
negative impact is also unattractive. The intuition here is that the harsher the threatened legislation is, the more difficult or perhaps impossible it will be to put it into law. While passing lenient legislation may be probable, enacting severe legislation—without any political compromise—is less plausible. Assuming all else remains equal, there seems to be an inverse correlation between the severity and probability of a threatened legislation. Following this logic, increasing the severity inevitably lowers the probability of the legislation, thus leaving its anticipated negative impact virtually unchanged and the firm’s incentive to comply insufficient. Hence, given the inverse correlation between severity and probability, increasing severity is in and of itself inconsequential.

Striving to make the probability of the threatened legislation greater than (or equal to) the effectiveness condition (or attempting to convince the firm that the probability is higher than it actually is), is therefore the best strategic option. Increasing the probability will satisfy the effectiveness condition and induce the firm to adhere to the legislator’s demands. Here, logrolling provides one important way in which the legislator can guarantee (or increase the likelihood of) sufficient political backing of the threatened legislation and thus higher probability of its enactment.

In an attempt to increase the probability of success, the legislator may also seek to trigger an availability cascade, a self-reinforcing process of collective belief formation, by which an expressed perception initiates a chain reaction that gives the perception increasing plausibility through its rising availability in public discourse. Applied to this context, educating the public of the importance of the underlying issues and changing public opinion in favor of the legislation may garner political support and strengthen the likelihood of the success of the threatened legislation.

violating the standards, and more effective enforcement can all increase the level of severity.

283 Obviously, the assumption here is that the firm is made aware of such changes, simply because information that is privately held by the legislator cannot influence the firm’s decision-making.

284 This correlation may be driven by several factors. First, harsher legislation creates antithetical policy stands, thus making a political consensus harder to achieve, unless a compromise is reached. Second, harsher legislation involves serious economic consequences, thus making it worth while for firms affected by the legislation to counter-lobby the legislation, thereby rendering its enactment less probable.

285 More specifically, increasing the severity will predictably have no effect on the expected impact of the threatened legislation, insofar as any alteration in the level of severity proportionately affects the probability.

286 Asymmetric probability assessments in which the legislator holds more accurate information than the firm does, may also lead the firm to believe that compliance is its best response.

287 See Thomas Stratmann, The Effects of Logrolling on Congressional Voting, 82 AM. ECON. REV. 1162 (1992) (vote trading is an important determinant of congressional voting behavior); see also Francesco Parisi, Votes and Outcomes: Rethinking the Politics-Like-Markets Metaphor, 13 EURO. J. L. & ECON. 183 (2002) (logrolling and political bargaining increase the predictability of the outcome for those who are involved in the process).

288 See Kuran & Sunstein, supra note 198, at 715-27. Specifically, the legislator may act as an availability entrepreneur and launch availability campaigns through the media and otherwise, all of which in order to instigate an availability cascade and manipulate the public opinion on the policy issue at question. Id. 733-36.

289 Research reveals that Congress acts in response to changes in public opinion more than two-thirds of the time. See Benjamin I. Page & Robert Y. Shapiro, Effects of Public Opinion on Policy, 77 AM. POLIT. SCI. REV. 75 (1983). Reinforcing this finding, Congress is at least as responsive as any legislative body in other leading democracies. See Joel E. Brooks, The Opinion-Policy Nexus in Germany, 54 PUBLIC OPINION QUARTERLY 508 (1990).
“Brinkmanship” is yet another tactic that increases the probability of enacting the threatened legislation into law. According to game-theoretic terminology, brinkmanship is the creation and gradual escalation of the risk of the threatened consequences. Applied to this context, the legislator can take various, non-mutually-exclusive actions that gradually and steadily raise the likelihood of the threatened legislation, continuing to the point at which the probability matches or exceeds the effectiveness condition. However, in order to achieve their purpose, these actions must be common knowledge. For example, negotiating with fellow lawmakers in order to secure sufficient political support is one form of legislative brinkmanship. Moving the legislative process forward is another. Inciting public opinion buildup concerning the policy in question, thereby attracting other lawmakers and gaining their political support, provides a third.

Its strategic appeal notwithstanding, brinkmanship has one noticeable disadvantage that reduces the legislator’s utility and negatively affects social welfare. While it may ultimately induce a firm to comply (i.e., when the probability is sufficiently high), it also gives an incentive to at first follow a “wait and see” approach. Therefore, mindful of the legislator’s brinkmanship tactics, the firm’s initial best response is “not comply.” Yet, if the probability of the threatened legislation subsequently increases so as to exceed, or at least equal, the effectiveness condition, compliance will then become the firm’s best response. In contrast, viewed from the legislator’s utility perspective, earlier compliance is preferable to delayed compliance. The logic here is that the legislator’s utility depends on several factors: (i) whether or not he was successful in inducing a change in a firm’s behavior; (ii) when that change was achieved; and (iii) what was the cost incurred by the legislator to induce compliance. This temporal preference is particularly pronounced when a legislator directs a threat towards several

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290 President Kennedy’s actions during the Cuban missile crisis of 1962 demonstrate nuclear brinkmanship, as it increased the risk of an all-out war and thus made compliance with U.S. demands to dismantle the missiles, Khrushchev’s best response. See Avinash Dixit & Barry Nalebuff, Thinking Strategically Ch. 8 (1991).

291 See Dixit & Skeath, supra note 219, at 451-59 (conceptualizing brinkmanship and examining the effects of this practice on strategic behavior in games). More colloquially, it is the art or practice of pushing a dangerous situation or confrontation to the limit of safety in order to force a desired outcome.

292 Brinkmanship turns the three-stage dynamic game (shown in Figure 1) into a multi-stage game, in which the firm’s failure to comply leads the legislator to take action in an attempt to increase the probability of the threatened legislation. Subsequently, the firm re-considers whether or not to comply. The firm’s failure to comply leads the legislator to take another action, thus even further increasing that probability; and so on.

293 Insofar as taking these actions sink the cost of legislation ex ante, in whole or in part, these actions also render the legislative threat credible (unless, of course, the threat is already credible). For a detailed discussion of the interaction between sunk cost and credibility see Section B(1) below.

294 Observations confirm that in many instances firms have dragged their feet and basically done nothing to comply for a considerable period of time. Clearly, non-compliance can be explained in several ways. First, the threat may be incredible, thus making non-compliance the firm’s best response. Second, assuming the threat is credible, delayed compliance may be due to the fact that the probability of the threatened legislation is lower than the effectiveness condition.

295 This temporal dimension is substantial insofar as the sooner the firm complies and reforms its objectionable behavior, the lower is the negative impact of its conduct on society and social welfare.
firms (e.g., an industrial sector). In this case, strategic delays, free-riding, and holdouts are widespread.

Seeking to guarantee early compliance, the legislator may threaten to increase the cost of compliance as time progresses. That is, a legislator threatens that if the firm does not comply early on, he will re-issue and extend the demands of the threat, thus making later compliance more costly. In order to make certain of the threat’s effectiveness in incentivizing early compliance, the forewarned increase in compliance expenses (per a given period of inaction) must not surpass the increase in the expected negative impact of the threatened legislation (as related to the legislator’s brinkmanship tactics during the same period of time).

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To conclude, in light of the preceding analysis, the assertion that “[l]egislative sagacity reduces itself to a judicious use of strategic behavior” now has secured a solid theoretical foundation.296

7. Extending the Analysis to Games with Perfect and Imperfect Information

In some cases, the legislator decides the contents of the threatened legislation such that, in terms of severity, it can be classified as lenient, moderate, or severe legislation. If enacted, the threatened legislation affects the firm in direct proportion to the leniency, moderation, or severity of its terms. The legislator also decides whether or not to reveal her choice. Hence, in an attempt to render the model as descriptive as possible of the real legislative landscape, this Section extends the analysis in order consider two more complex strategic situations in which the legislator decides (i) the severity of the threatened legislation, and (ii) whether or not to disclose the chosen level of severity to the firm.297 In turn, these choices give rise to games with perfect and imperfect information, which I model and examine in this Section.

Figure 2, shown below, represents in an extensive form a game with perfect information. The notion of perfect information captures the fact that both players hold equal amounts of pertinent information. Consistent with some casual observations, the game is predicated on the assumption that the legislator decides the level of severity (e.g., lenient, moderate, or severe) and reveals this choice to the firm.298 The level of severity is therefore a matter of common knowledge. The firm’s payoff reflects the cost of compliance;299 and the negative impact of the threatened legislation (that is, if enacted).300 The legislator’s payoff reflects the cost of enacting the threatened legislation.

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296 This statement is associated with Norwegian-American economist and sociologist Thorstein Veblen.
297 The firm, it is understood, knows that any threatened legislation can be lenient, moderate, or severe.
298 See, e.g., Markhoff, supra note 120, at C8 (describing the information exchanged in the meeting between government officials and industry participants, including a draft legislative proposal that would have required companies to disclose their security status in the financial reports they file with the SEC).
299 The cost of compliance is fixed at 5 because I assume that the legislator’s demands remain unchanged irrespective of the level of severity of the threatened legislation.
300 The negative impact of lenient, moderate, and severe threatened legislation is 10, 20, and 30, respectively. The magnitude of these costs increases with the severity of the threatened legislation.
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legislation; and the benefits received if the legislator is successful in inducing the desired change in conduct.

This game is identical to the game I have discussed earlier (depicted in Figure 1), with one exception: the legislator may choose between three levels of severity. Consistent with earlier analysis, the equilibrium behavior depends on (i) whether the threat is credible, and (ii) whether the probability that the threatened legislation is enacted into law is higher or lower than the effectiveness condition. Surely, where the threat is incredible (for reasons I explain in Section B below), the firm’s best response is “not comply” and the legislator’s best response is to not carry out the threat. In equilibrium, the threat is ineffective in inducing a change in behavior.

Credibility, however, may shift the equilibrium behavior from non-compliance to compliance. When the threat is credible, the firm’s assessment of the probability of the threatened legislation turns out to be the decisive factor underlying the threat’s inducement effect, namely—that probability distinguishes between compliance (i.e., credible threat compliance equilibrium) and non-compliance (i.e., credible threat non-compliance equilibrium). The issue, therefore, is whether the threatened legislation satisfies the effectiveness condition (which, as defined earlier, is the lower-bound probability below which the firm will consider compliance an inefficient strategy, even if the threat is credible or believed to be so). Given the probabilistic nature of legislative threats, this condition is derived from (i) the cost of ex ante compliance with the legislator’s demands; and (iii) the ex post adverse impact of the threatened legislation which, we know, increases with severity. As the cost of ex ante compliance remains fixed regardless of the level of severity, the higher is the level of severity of the threatened legislation, the lower the effectiveness condition becomes; and vice versa. Here, the intuition is that if the consequences of the threatened legislation are very harsh, it makes perfect sense to comply and avert these consequences even if the probability that they materialize is rather low.

Importantly, while the effectiveness condition derives solely from the level of severity (and the fixed cost of ex ante compliance), the probability that the threatened legislation will be enacted into law is contingent upon numerous factors, only one of which is the level of severity. This insight explains why, when firms are perfectly

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301 I consider that the cost of enacting the threatened legislation increases with severity and is 2.5, 5, and 10, respectively. This cost grows in severity for a number of reasons. First, higher severity may require higher investment of time and resources in research and drafting. Second, with higher severity, the opposition in Congress may be stronger, thus requiring more time for securing adequate political support. It is no secret that time is one of a legislator’s most precious resources. See Thomas O’Donnell, Controlling Legislative Time, in THE HOUSE AT WORK 138 (Joseph Cooper & G. Calvin Mackenzie, eds., 1981) (it was said of House members’ that their “ability to concentrate time on any single [issue] is severely constrained by the abundance and complexity of the demands that confront them”). For further discussion see the text and references cited in note 248 above.

302 The benefit of inducing a firm to adopt desirable practices and abandon undesirable ones is 5.

303 Technically, the issue concerns the difference between the probability of the threatened legislation and the effectiveness condition. The legislative threat’s inducement effect is bound to exist provided that that difference is greater than or equal to zero.

304 Different factors that may influence legislative behavior in Congress and, consequently, the likelihood of the threatened legislation are discussed in the text accompanying notes 270-277 and 287-293 above.
informed, the threatened legislation is of high level of severity. Specifically, seeking to maximize her utility—namely, by ensuring that compliance constitutes the firm’s best response and thus avoiding the cost of carrying out the threat—the legislator may threaten severe legislation, thereby lowering the effectiveness condition. Thus, assuming all else remains equal, the lower the effectiveness condition becomes the higher is the chance that the threatened legislation satisfies the effectiveness condition and the more likely is the firm to comply. In other words, facing the firm with harsher threatened legislation guarantees a more potent threat. Lastly, assuming all else remains equal, choosing a higher level of severity increases the legislator’s expected utility from issuing that threat, thus making her better off ex ante.

The legislative threat that was directed towards colleges and universities in 2003, which threatened to impose financial penalties on institutions that raised tuition too sharply, demonstrates these points. Amid the national debate over the threatened legislation, universities and colleges—including, among many others, Harvard, George Washington, and the University of Virginia—have announced voluntary plans to freeze tuition, increase financial aid, or remove the burden of loans from some students.305 Consistent with the present theoretical predictions, even though the “chances for passage were always questionable,” universities complied with the legislative demands to curb tuition rise because the legislation “has stood out as the most punitive of the federal proposals to contain sharp increases in college prices.”306 Consequently, republican lawmakers at the House announced that they would withdraw the threatened legislation which was “no longer necessary because universities seemed to have gotten the message and were taking steps of their own.”307

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305 See Winter, supra note 277, at A14 (“[I]nstitutions across the nation are making earnest efforts toward that end. … Harvard said it would no longer ask for any financial contribution from parents earning less than $40,000 a year and would scale back the amount it expected from those earning less than $60,000”).
306 Id. (the threatened legislation “would have stripped them of their eligibility for millions of dollars in federal grants and programs”).
307 Id.
Figure 2. Extensive form representation of the legislative threat game with perfect information and three levels of severity

In contrast, Figure 3 represents in extensive form a game with imperfect information, which captures situations where one player holds more information than the other. The allocation of information in this game is imperfect because the legislator does not reveal the level of severity, thus keeping it privately-held information. This assumption is consistent with casual observations, according to which rarely do legislators divulge such information. Even more, in some cases the legislator is in fact—or pretends to be—undecided on the contents of the threatened legislation at the time she issues the

308 For this reason, this too is a game with asymmetric information; one in which one player holds more information than the other. See Rasmusen, supra note 228, at 49-50.
threat. Absent specific information that indicates otherwise, there is an equal chance that the threatened legislation will be lenient, moderate, or severe. Hence, the assumption of imperfect information captures these situations, in which the legislator has not decided what the threatened legislation would be like.

The dashed elliptic denotes imperfect information: while the firm knows that the legislator has issued a threat and knows that, severity-wise, the threatened legislation may be lenient, moderate, or severe, it does not know (and cannot otherwise observe) what the level of severity actually is. Hence, the firm does not know which of the three game positions it is at. The firm’s compliance (or non-compliance) decision is therefore made in utter ignorance of the level of severity of the threatened legislation.

Consistent with the earlier analysis, the predicted equilibrium behavior depends on the following: (i) whether the threat is credible, and (ii) whether the probability that the threatened legislation is enacted into law is higher or lower than the effectiveness condition. Where the threat is incredible (for reasons I explain in Section B below), the firm’s best response is “not comply” and the legislator’s best response is to not carry out the threat, thus constituting the incredible threat equilibrium. Absent credibility, the threat is utterly ineffective in inducing an equilibrium change in behavior.

Credibility, however, may shift the equilibrium behavior from non-compliance to compliance. Where the threat is credible, the firm’s probability assessment turns out to be a decisive factor on which the legislative threat’s inducement effect depends. In other words, higher or lower probability will distinguish between compliance (i.e., credible threat compliance equilibrium) and non-compliance (i.e., credible threat non-compliance equilibrium). Viewed from the firm’s perspective, the issue is whether the probability is higher or lower than the threat’s effectiveness condition. Thus, in order to choose its best response efficiently, the firm must figure out what the effectiveness condition is. But this means the firm must be able to tell the level of severity, with respect to which it is (presently assumed to be) imperfectly informed. Short of such information, the level of severity remains uncertain. Given these circumstances and

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309 Presumably, a legislator may not initially decide the level of severity in order to reduce the cost of research and drafting and the cost of enacting the legislation if she is called upon to carry out the threat.

310 The firm can tell when the legislator has issued an explicit or implicit threat. In the case of anticipatory threats, however, the legislator does not issue a threat at all; rather, there is some probability that a legislative threat will be issued in the future. Thus, hard knowledge is replaced with probabilities that the firm assigns to each of the possible choices the legislator can make, which need not add up to 1.

311 Of course, the firm can gauge the chance (i.e., risk) that the legislator will choose a lenient, moderate, or severe threatened legislation. For example, there may be 15 percent chance of a lenient legislation, 30 percent chance that the threatened legislation will be moderate, and a 5 percent chance it will be severe. Notably, in the case of anticipatory threats these probabilities do not total 100 percent because these compound probabilities account for the risk that a threat will be issued. Yet, in the absence of sufficient information and given uncertainty concerning the level of severity, these probability judgments are nothing but a guess. Given this uncertainty, there is no a priori reason to believe that these risks are not equal (e.g., 10%-10%-10%).

312 This is known in game-theoretic parlance as an information set. Meaning that, a player (here, the firm) is unable to discriminate among positions when choosing an action because he cannot observe the prior choices made by the other player. See Vega-Redondo, supra note 252, at 7.

313 In order to resolve this uncertainty, the firm may assess the likelihood of any particular level of severity. Any such assessment, however, requires some information which the firm is presently lacking.
absent specific information to the contrary, the firm rationally assumes that the chance of lenient, moderate, or severe legislation is equal. Averaging out these chances, the firm effectively faces a threat of moderate legislation and is able to derive the effectiveness condition accordingly.\footnote{Given that the cost of compliance remains fixed, the higher the level of severity of the threatened legislation, the lower the effectiveness condition becomes; and vice versa.}

How, then, does imperfect information affect the threat’s inducement effect and, in turn, the firm’s equilibrium behavior? As a general matter, imperfect information may induce the firm to comply in circumstances it would not have otherwise complied had it been perfectly informed. In other words, imperfect information is strategically valuable because it may trigger the threat’s inducement effect, thus making the threat an effective means to induce a change in behavior, even where the prospects of the threatened legislation in Congress are relatively insignificant. This effect is due to the fact that the lower the effectiveness condition is, and assuming all else remains equal, the higher the chance that the threatened legislation satisfies that condition.

To illustrate this point consider, for example, the case of lenient threatened legislation, with respect to which the effectiveness condition is relatively high. Compliance in this case is inefficient and therefore irrational unless the probability that the threatened legislation is enacted into law is sufficiently high (i.e., it exceeds the effectiveness condition) such that the expected negative impact of the threatened legislation is at least equal to or greater than the cost of ex ante compliance. If, however, the probability that the threatened lenient legislation can pass congressional muster is sufficiently low (i.e., it falls below the effectiveness condition), “not comply” emerges as the firm’s best response.\footnote{As I have explained, the probability of the threatened legislation may fall below the effectiveness condition for a variety of reasons.} This may be the case, for example, where the known contents of the threatened legislation draw significant opposition, thus making its enactment highly unlikely. Yet, keeping information strategically private and injecting some uncertainty can induce the firm to comply notwithstanding the low probability that would have otherwise prevailed. As explained above, if the firm is imperfectly informed and thus uncertain about the level of severity, it will make its decision as if it faced a threat of moderate legislation, with respect to which the effectiveness condition is significantly lower (compared with the condition for lenient legislation). As the contents of the threatened legislation remain undisclosed, the average probability of that legislation becomes higher. Thus, driven by uncertainty, a lower-than-otherwise effectiveness condition makes compliance more likely. Assuming all else remains equal, there is a higher chance that the threatened legislation satisfies a lower-than-otherwise effectiveness condition, thus making the inducement effect more likely.
B. The Inducement Effect: Conditions which Make Legislative Threats Credible (or, Rather, Incredible)

The analysis presented above as well as casual observations confirm that legislative threats can be highly effective in inducing sea-change reforms in the conduct of firms and organizations, thus forcing them to abandon existing practices in favor of adopting socially-desirable ones. The analysis has specifically shown that the inducement effect

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316 It is telling that following the threat of legislation to protect consumer privacy and restrict the flow of personally-identifiable information, it was reported that the retail “industry is certainly doing more than it’s
A Theory of Legislative Threats

of legislative threats (or, rather, its absence) crucially depends on the credibility (or, rather, the incredibility) of the legislative threat and the credibility (or, rather, the incredibility) of the implicit promise to forbear from seeking to enact the threatened legislation. In other words, unless the threat is credible (and the probability of the threatened legislation becoming a law is sufficiently high), legislative threats are bound to remain ineffective in regulating social conduct.317

Yet, to begin with, is there any reason to believe that legislative threats (and legislative promises) are credible? Even more, in which circumstances does the threat to enact adverse legislation qualify as a credible threat and the promise to forbear from doing a credible promise? Lastly, are there any mechanisms that legislators can avail themselves of so as to ensure the credibility of threats? The following analysis attempts to answer these questions, thereby determining the conditions that render legislative threats credible. Casual observations and several case studies are used throughout the analysis to demonstrate these conditions.

Intuitively, the strategic choices that players make crucially depend on what one player (i.e., the firm) believes the other player (i.e., the legislator) will do in a particular situation (i.e., where the firm does not comply or where the firm does comply). Given this inextricable linkage, strategic behavior includes all sorts of actions designed to influence the beliefs and, as a corollary, players’ choice of strategies.

Research in the theory of games provides insights into the conditions that make threats and promises credible or incredible.318 In general, a threat may become credible ex ante and thereby lead the other player to believe and expect that his opponent will carry out the threat if called upon to do so in three analytically-distinct situations.319
First, a threat is credible if it is accompanied in advance by an action that makes the exercise of the threat after the demand had been violated (i.e., ex post) an optimal choice because it maximizes the threat-maker’s utility (“pre-game commitments”). Second, a threat may become credible because the threat-maker stakes her reputation on fulfillment of the threat if called upon to do so (“reputation”). Third, a threat may also be considered a credible threat where the threat-maker’s decisions (are believed by others to) reflect irrational or emotional motivations that drive that player to undertake activities beyond the bounds of pragmatic self-interest (“emotions”).

In sum, unless the threat-maker makes a pre-game commitment, is known to have reputation, or is known to be motivated by specific emotions, the threat will be incredible. Seeking to gain credibility, legislators can employ a variety of practical devices and exhibit different preferences that effectively bind them to carrying out the threats ex post, thus making the legislative threat credible ex ante. Building upon these analytic insights, the discussion that follows below delineates cases in which legislative threats are expected to be credible.

1. Commitments

Ex ante commitment binds a player to carrying out his threat ex post because doing so maximizes the player’s utility and is therefore optimal. In theory, effective (that is, credible) commitment must satisfy two conditions, namely—(i) the commitment must be irreversible; and (ii) the player must signal the commitment to the other player, thus making it visible and known to the other player (or, otherwise, the commitment will have no effect on the other player’s beliefs and none on his behavior in the game). If these conditions are satisfied, the threat will be afforded credibility ex ante.
More concretely, a player can ensure that exercising a threat will be the optimal choice *ex post* and thereby commit himself *ex ante* to carrying out the threat in three different ways, namely—(i) by reducing the cost of carrying out the threat; (ii) by increasing the benefit from carrying out the threat; and (iii) by limiting the freedom of choice so as to eliminate any option other than carrying out the threat. Whereas the first two methods are designed to increase the expected payoff from exercising the threat (so as to make that choice truly optimal), the third method eliminates potentially-attractive strategies (in the utility sense) that the player would have been able to choose from and, essentially, obliges the threat-maker to carry out the threat (which, by definition, is a self-harmful strategy). In reality, eliminating the other options does not mean that the threat-maker will *actually* suffer the harm or incur the loss for, if the threat is credible (which, expectedly, it will be if the commitment is effective), then the threat-recipient will comply and the threat-maker will need not exercise the threat. In other words, an effective commitment is designed to prevent the exercise of the threat.

Applying these insights to the landscape of legislative threats, legislators may—and, in reality, often do—use a number of practical devices to credibly commit themselves to carrying out their threats.

To begin with, legislators can reduce the cost of carrying out the threat. To that end, they may join co-sponsors, enter into political coalitions, and establish alliances with fellow lawmakers which, conceivably, can reduce the cost that each legislator incurs in enacting the legislation. Legislators may also opt to sink the cost of enacting the adverse legislation in advance (that is, prior to making the threat). In particular, the legislator and her staff can do the preparatory work necessary to enact the threatened legislation, including gathering relevant data, drafting the proposed bill, consult the Office of Legislative Counsel on drafting matters, negotiate with other legislators to ensure political support, hold committee hearings, and take other actions that will streamline and reduce the remaining cost of the legislative process. Having sunk these costs, the cost-benefit of carrying out the threat (which, as stated above, is otherwise costly to the legislator) changes dramatically. In other words, the higher

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325 Here it is *rationality* (or, more precisely, rational utility-maximization) that works as a mechanism that commits the legislator to exercise the threat. However, if the legislator was to behave irrationally, higher payoffs would not guarantee that he actually carries out the threat.

326 The latter method embraces the counter-intuitive notion that in the realm of game theory fewer options are of strategic value insofar as they shape the beliefs and expectations of the other player as to what his opponent’s future response will be.

327 Because what matters in this context is what the other player believes his opponent will do after the fact (that is, carry out the threat or do nothing), the legislator can pretend to have sunk the cost of enacting the adverse legislation and make the firm believe that the cost is by and large sunk. Whether or not this strategy is successful, however, depends on whether the legislator can convey this impression credibly and on whether or not the firm can verify such information.


329 See Rasmussen, supra note 228, at 98-99 (discussing the strategic use of sunk costs). I assume that introducing and passing a bill entails some *fixed costs*, including the cost of research and data-gathering, the
the sunk costs (relatively to the total cost of enacting the threatened legislation), and assuming all else remains equal, the more attractive (in the utility-maximizing sense) does carrying out the threat become. Lastly, to ensure that such actions gain public exposure and forewarn targeted firms of the threat’s credibility, legislators often hand-out drafts of the threatened legislation to targeted firms and trade organizations and publicly discuss their effort to further policy objectives.330

Taking actions that increase the expected benefits from carrying out the threat (and, hence, ensure a positive net payoff) is yet another way in which legislators can render their threats credible ex ante.331 The idea here is that increasing expected benefits from carrying out the threat so as to exceed expected costs, turns the exercise of the threat into a utility-maximizing choice (that is, compared with not exercising the threat).332 To the extent that the benefits to the legislator from carrying out the threat derive from enhancing her reputation (e.g., for promoting responsible policies333), then educating the public about the policy concern in question and building up the public’s interest in the particular reform will increase the legislator’s reputational and consequential benefits.334 Such benefits may include high constituency satisfaction, higher chance of re-election, and increased campaign contributions.335

In an attempt to strategically condition the public’s opinion, a legislator may induce an availability cascade, a process by which an expressed concern initiates a reaction that gives that concern increasing visibility through rising availability in policy discourse.336

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330 See, e.g., Markhoff, supra note 120, at C8 (reporting that government officials handed-out a draft legislative proposal to industry representatives with whom they met to discuss policy concerns).

331 Viewed from another perspective, these actions are different forms of investment which the legislator makes in order to make carrying the threat out optimal. Once the investment is made, the legislator can recoup returns on the investment only if he carries out the threat, thereby guaranteeing the credibility of the threat. See Tai-Yeong Chung, On Strategic Commitment: Contracting versus Investment, 85 AM. ECON. REV. 437 (1995).

332 As shown in Figure 2 above, the payoff for carrying out the threat is always lower than the payoff for doing nothing. Thus, increasing the expected benefits from carrying out the threat so as to exceed the payoff from doing nothing will make the former strategy an optimal choice and the latter an inferior.

333 Cf. John W. Kingdon, Congressmen’s Voting Decisions 248 (1989) (“most members [of Congress] have their conceptions of good public policy, and act partly to carry that conception into being”). See also Hall, supra note 215, at 69 (legislative activism is related to liberal members’ belief in federal action as an effective instrument for social betterment).

334 Raising the visibility of the social interest is one way of doing so. For example, Rep. McKeon, who successfully used a legislative threat to curb college and university tuition increases, “brandished the threat of legislation for seven months before actually introducing a bill” and stated that he had wanted “to raise the visibility of the issue because we just can’t keep going on as we are.” See Winter, supra note 277, at A14.


336 See Kuran & Sunstein, supra note 198, at 715-27.
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Hence, using committee hearings and meetings with industry representatives to publicly convey the weighty policy concerns the threatened legislation is designed to address, a legislator may be able to strategically condition the public’s opinion and increase political support for the threatened legislation. In this respect, highly-visible hearings may signal the seriousness of the underlying concern and the keen interest in acting on the issue. Furthermore, gathering and publicly presenting data that demonstrate the negative consequences of the targeted practices for social welfare and other national interests and, as a corollary, establish the considerable interest in reforming these practices serves precisely the same purpose. In sum, making the effort to maintain a tough stance on policy issues and demonstrating a benevolent, proactive approach to social affairs renders the legislator’s threats credible and therefore pays off.

Moreover, a legislator can commit herself to carrying out the threat by limiting her choice of strategies, namely—by eliminating any option other than carrying out. In order to render the threat credible, the firm must be made aware of this “hands tying.” One way to limit the legislator’s choices is to enact the threatened legislation as a slightly modified “sunset law.” Specifically, the legislator can enact the threatened legislation, adding a deferral clause and a sunset clause: (i) the deferral clause defers the act’s effective date so as to allow threat-recipients sufficient time to comply with the legislator’s demands; (ii) the sunset clause provides that the act will...
expire (i.e., complete sunset) or be suspended (i.e., pro tempore sunset) if and when predetermined observable compliance criteria are met. While it might be impossible to directly observe compliance measures the firm has taken (e.g., internal controls, risk-reduction measures, etc.), it is certainly possible to monitor the firm’s processes and output for compliance using, among other things, testing and auditing. In any event, the firm has strong incentives to give a signal showing it has adequately complied.

Yet, because the “sunset law” can be repealed at any point of time, this commitment is not irreversible and hence does not guarantee complete credibility.

Similarly, delegating the power to exercise the threat (as well as the responsibility to keep the implicit promise to forgo the threatened legislation) to a subordinate agent who is required to follow preset rules and procedures can also be used to limit the legislator’s ex post choice of strategies and thereby render the threat credible ex ante. Such delegation can only be effectuated by statute. In order to ensure credibility, the legislator may choose, for example, to delegate the power to a reputable agency (e.g., that is known for its subservient performance) or, alternatively, to one captured by a special interest consistent with the threatened legislation. Delegation does not guarantee complete credibility, however, because theoretically the delegation of power can be revoked at any point.

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343 From the legislator’s perspective, temporary suspension is preferable to expiration because once the act has expired and can only be reinstated by legislation the threat of adverse legislation ceases and, assuming all else remains equal, the firms to which the threat was directed have no incentive to maintain compliance.

344 This modified sunset law employs the intuition of automatic fulfillment, which serves as a commitment device: a threat-maker can relinquish her freedom of choice by devising an independent, self-executing mechanism that determines whether or not to exercise the threat. See Dixit & Skeath, supra note 219, at 308.

345 For example, it is possible to check whether firms have reduced greenhouse gas emissions or whether steroid use by professional athletes has subsided. Cf. Monitoring Proforma for Commercial Leases Code of Practice, supra note 165 (U.K. government appointed monitors to ensure implementation of the code in the property sector, in accordance with the legislative threat).

346 Cf. Jean-Jacques Laffont & David Martimort, The Theory of Incentives: The Principal-Agent Model 68-9 (2002) (discussing a situation in which a contract can be conditioned on observing ex post a signal that provides useful information on the underlying state of affairs).

347 See Dixit & Skeath, supra note 219, 301, 308-309 (discussing the strategic role of delegation in reducing a player’s ex post freedom of choice and in facilitating credibility).

348 See Dixit & Skeath, supra note 219, at 301-302 (delegating power to exercise the threat to an agency captured by special interest is strategically valuable). See also Sebastian Krapohl, Credible Commitment in Non-independent Regulatory Agencies: A Comparative Analysis of the European Agencies for Pharmaceuticals and Foodstuffs, 10 EURO. L.J. 518 (2004) (agency’s institutional structure is a determinant of the credibility of delegation).

349 Furthermore, delegating power to a captured agency is problematic because it creates the risk that the agency will exercise the threat irrespective of whether or not threat-recipients comply, thus stultifying the threat’s purpose. While such delegation may facilitate the threat’s credibility, it may also undermine the credibility of the implicit promise to forbear, thus diminishing ex ante incentives to comply. See Ernesto Dal Bo & Rafael Di Tella, Capture by Threat, 111 J. POLIT. ECON. 1123 (2003) (when policy-makers are threatened by “nasty” interest groups, good policies are less likely to be chosen or implemented).
2. Reputation

Maintaining good reputation for honesty, integrity, toughness, benevolence, or simply for carrying out a threat if and when predetermined triggering conditions are met will make the threat a credible threat \textit{ex ante}. Here, the intuition is that given the threat-maker’s good reputation, it is in her best interest (and, therefore, her best response) to avoid doing anything that adversely affects her reputation and reduces her utility.\footnote{It makes sense (utility-wise) to forgo a small cost-saving in a particular game in order to avoid negative repercussions in future games which, by definition, are greater. For a non-formal explanation of the strategic value of reputation and its effect on behavior see Kreps, supra note 218, at 65-72.} In that respect, failing to carry out a threat despite non-compliance clearly damages one’s reputation and reduces expected payoffs from future games. This is because the existence of reputation creates an \textit{implicit linkage} between the acts taken in the present game and the payoffs received in future games.\footnote{In other words, the payoffs from future games are contingent upon behavior in earlier games. Hence, when considering any one of these games, the threat-maker should adjust expected payoffs to account for potential repercussions for damaged reputation.} Under these conditions, the threat is \textit{ex ante} credible because given that the threat-maker stakes her reputation on carrying out the threat, and given further that carrying out the threat in the present game maximizes her utility in the long-term, this is precisely what she is expected to do. Logically, the existence of this reputation also ensures the credibility of the implicit promise to forbear from exercising the threat if the threat-recipient complies. In other words, given the existence of reputation, past behavior guides future behavior.

More concretely, in the course of her political tenure, the legislator may develop and maintain good reputation for promoting consistent policies; for taking a tough stance on defined policy issues, including a given one presently in question; for advancing specific causes; and for high integrity (that is, for keeping her words and promises). As Gordon Tullock has noted, albeit in a different context, “politicians may sometimes have to enact legislation … just as the \textit{Cosa Nostra} occasionally burns down the buildings of those who fail to pay its protection levies.”\footnote{See Gordon Tullock, \textit{Rent Seeking} 74 (1993).} The legislator’s good reputation credibly commits her to pursuing the threatened legislation if the firm does not comply and, conversely, to foregoing the legislative measure if her demands are adequately met.\footnote{This discussion focuses on the legislator’s good or bad reputation for carrying out the legislative threat (that is, reputation is assumed to be a one-sided issue). The discussion does not consider, however, the firm’s or the industry’s good or bad reputation for complying with legislative threats (that is, where the role of reputation is two-sided). See Rasmusen, supra note 228, at 117-18. Developing such reputation is not implausible because, as repeat players, firms are routinely subject to threats of legislation. Developing good reputation is valuable because it reduces the cost of regulatory bargaining and enables the legislator and the firms to devise a mutually-efficient solution. Cf. Jackson, supra note 197 (a firm’s reputation is essentially a form of capital). Moreover, whether repeated threats (targeting different behaviors) are made by the same legislator or, rather, by others is inconsequential because the behavior of the firms in these games and hence their reputation (or lack thereof) can be observed by all legislators (theoretically, even in future congresses).} Mindful of this reputation, firms are expected to believe that the legislative threat is indeed credible. These firms will comply with the legislator’s...
demands because, given the threat’s credibility, compliance will maximize the firm’s utility and make it best-off, thus making this strategy the only prudent choice.\footnote{Notably, legislative threats will remain credible as long as the legislator has reputation to protect and as long as maintaining that reputation is efficient, namely—insofar as the future benefits from that reputation exceed the short-term cost of maintaining it (i.e., the cost of enacting the threatened legislation). Thus, if there are no more opportunities to use that reputation—namely, where the legislator’s term in office ends—the threat will necessarily turn incredible. Assuming the firm is mindful of the game’s last round, it will have no incentive to comply. See Kreps, supra note 218, at 70.}

Clearly, investing in reputation-development and maintaining that reputation makes the legislator better-off in a several ways.\footnote{In the present game, the legislator’s investment (in utility terms) in reputation-development is equal to the cost (i.e., the negative payoff) of exercising the threat when called upon to do so. The case of lenient, moderate, and severe legislation is 2.5, 5, and 10, respectively (i.e., the payoffs from exercising the threat are -2.5, -5, and -10, respectively). These payoffs are shown in Figure 2 above.}

First, maintaining good reputation is worth more than any short-term benefits that the legislator may obtain by sullying her reputation. For example, the credibility-assurance of good reputation enables the legislator to promote public policies without enacting the desired policy into law and without incurring the significant cost of doing so.\footnote{Numerically, enacting the threatened legislation (when the firm does not comply) is costly to the legislator (e.g., the payoff for lenient threatened legislation is -2.5). If the firm complies, the legislator benefits from achieving the desired policy reform while doing nothing (e.g., the payoff is 5). Hence, having no reputation of any kind or having bad reputation entails a loss of 7.5 utility units. See Figure 2 above.}

In other words, the legislator’s reputation guarantees the threat’s inducement effect on behavior; makes the threatened legislation unnecessary and its costs redundant; and increases the legislator’s utility. Hence, good reputation is crucial for securing threat-induced compliance.

Second, given that the legislator’s reputation is normally widely-known public information, it stands to reason that current, potential, and repeat threat-recipients should be able to take notice of that reputation, appreciate the credibility of the legislator’s explicit, implicit, and anticipated legislative threats, and behave accordingly, thus reinforcing the legislator’s political status and enhancing her political capital.\footnote{The repeated nature of the game ensures that any type of reputation will be widely known. See Dixit & Skeath, supra note 219, at 310-311 (reputation becomes valuable if future players can observe actions the threatmaker has previously taken in games played with others).}

Third, putting effort towards advancing a policy agenda and maintaining a good reputation is in the best interest of the legislator insomuch as failure to do so has an electoral price (e.g., lower chance of re-election). Indeed, empirical research shows that legislators’ campaign contributions are positively correlated with their reputation.\footnote{See, e.g., Randall S. Kroszner & Thomas Stratmann, Corporate Campaign Contributions, Repeat Giving, and the Rewards to Legislator Reputation, 48 J. L. & ECON. 41 (2005) (reputational development is rewarded with political contributions). Legislators’ reputation also guarantees cooperation between legislators and constituents. See Kroszner & Stratmann, Interest Group Competition and the Organization of Congress, supra note 194.}

Taken together, these points explain why legislators with better reputation are generally more successful and are more likely to win re-election than legislators who have no reputation at all (e.g., junior legislators with short track-record) or those who are known to have bad reputation.
Good reputation for honesty, integrity, toughness, benevolence or simply for keeping one’s words and promises evolves over time as firms, organizations, and other potential threat-recipients observe the ways in which the legislator has acted in previous strategic interactions and learn of the legislator’s reputation. The longer and more intensive is the interaction between the legislator and the firms (i.e., currently or potentially targeted), and the farther away the time horizon, the more likely is it that the legislator will acquire good reputation. Indeed, research shows that legislators sitting on congressional standing committees avail themselves of repeated interaction with firms which foster reputation-building.\(^{359}\)

3. Emotions

Intuition and casual observations reveal that emotions may wield formidable impact on behavior, thus compelling individuals to take actions that at first glance seem inconsistent with their utility-maximizing self-interest.\(^{360}\) Confirming this bare intuition, social psychologists demonstrate the power of consistency and other emotional motivations in directing human behavior. For example, experiments show that individuals exhibit a tendency for behaving in ways that are consistent with their earlier statements and positions.\(^{361}\) It follows that commitment (this time, in its ordinary literal sense) has the capacity to constrain future behavior.

Formalizing these insights into refined economic models, economists Jack Hirshleifer\(^{362}\) and Robert Frank\(^{363}\) explain why certain emotions, passions, and moral sentiments—including, among others, righteous anger, vengeance and meanness, vanity, the desire to satisfy public outrage,\(^{364}\) altruism and public spirit,\(^{365}\) decency, and

\(^{359}\) It is argued that congressional standing committees foster repeated interaction between legislators and constituents, thus facilitating reputation-building without which legislators cannot maximize contributions. See Kroszner & Stratmann, \textit{Congressional Committees as Reputation-building Mechanisms}, supra note 195 (presenting empirical data that support this argument).

\(^{360}\) Bringing a legal action against a transgressor despite the near-zero probability of winning that suit is a common example that demonstrates such “emotional” behavior. Cyclical attacks and actions of revenge, which are common in some communities or where the rule of law is ineffective in maintaining the social order, provides additional example of “emotional” conduct. Refraining from cheating, even when one knows he cannot be caught or punished, makes the same point.

\(^{361}\) See Robert B. Cialdini, \textit{Influence: The Psychology of Persuasion} 67-75 (rev. ed. 1993) (“If I can get you to make a commitment (that is, to take a stand, to go on record), I will have set the stage for your automatic and ill-considered consistency with that earlier commitment”).

\(^{362}\) See Hirshleifer, supra note 323, at 307, 308-309 (emotions that drive people to act beyond the bounds of pragmatic self-interest facilitate credibility and thus are not necessarily adverse to that person’s self-interest). See also Rasmusen, supra note 228, at 101-102 (enumerating various emotional motivations).


\(^{364}\) The Rodney King trials in the early 1990s demonstrate the role of emotional motivations. State prosecutors brought cases against the policemen who beat Rodney King regardless of the merits of these claims in order to satisfy public outrage. See Rasmusen, supra note 228, at 101.

\(^{365}\) See Thomas C. Schelling, \textit{Altruism, Meanness, and Other Potentially Strategic Behaviors}, 68 \textit{Am. Econ. Rev.} 229 (1978) (arguing that altruism and meanness are of strategic value insofar as they influence others by affecting their expectations of what the altruist or mean individual will do).
care for fairness\textsuperscript{366}—commit individuals to undertaking activities beyond the bounds of pragmatic self-interest.\textsuperscript{367} Paradoxically, while emotion-driven behaviors ordinarily appear to be in conflict with one’s self-interest (and, hence, irrational), such behaviors actually promote self-interest.\textsuperscript{368} Indeed emotions and other seemingly-irrational motivations may serve one’s narrow self-interest very well precisely because specific emotions act as commitment devices that bind a person to behaving in a particularly predicted way (namely, that is in line with that emotion, passion, or preference).\textsuperscript{369} To illustrate, where others believe that the threat-maker with whom they are dealing is motivated by a given emotion or preference (say, pride and vengeance), they will soon realize that that person will carry out the threat even if the costs of doing so are prohibitive. In fact, given this emotion or preference, the benefits from exercising the threat are far greater than those that would have otherwise accrued (that is, absent the ensuing emotional sense of fulfillment).\textsuperscript{370} It is precisely this sort of belief—namely, that the threat will be carried out even if it is not in the threat-maker’s material interest to do so—that makes the threat a credible threat. Mindful of these emotions, the threat-recipients will have strong incentives to comply with the threat-maker’s demands.

Emotions, preferences and other motivating sentiments are certainly not at odds with the province of legislation and public policy. In keeping, Nobel laureate economist James Mirrlees wrote that “government ministers [ought] to try to maximize utility, even if their personal sense of achievement is gravely compromised, their crazy industrial dreams unfulfilled.”\textsuperscript{371} It follows that a legislative threat may turn credible if the firms towards which the threat has been directed correctly or erroneously believe—based on public information and previous behavior or due to the legislator’s attempts to strategically change their mind\textsuperscript{372}—that the legislator is driven by specific emotions and motivations that the threatened legislation (of failure to comply with the legislator’s demands) can affect. Different emotions and preferences, including benevolence, public spirit, equality, toughness, accountability, consistency, and the care for fairness among

\textsuperscript{366} The care for fairness encompasses different preferences and notions of fairness, including that of keeping one’s promises. See Louis Kaplow & Steven Shavell, Fairness versus Welfare 38-45 (2002).

\textsuperscript{367} The effects of passions and emotions on human behavior and social interaction have occupied social theorists and moral philosophers for ages. See generally Albert O. Hirschman, The Passions and the Interests: Political Arguments for Capitalism before its Triumph (1977) (arguing that capitalism was originally supposed to accomplish exactly what was soon denounced as its worst feature, namely—the repression of the passions in favor of the “harmless,” if one-dimensional, self-interest). Indeed, even Adam Smith, who subscribed to the credo of perfectly rational self-interested behavior, was concerned with how human nature constrained the pursuit of self-interest. See Ronald H. Coase, Adam Smith’s View of Man, 19 J. L. & ECON. 536, 542-43 (1976).

\textsuperscript{368} See Hirshleifer, supra note 323, at 308 (“A person can sometimes best further his self-interest by not intending to pursue it”) (emphasis in original).

\textsuperscript{369} See Frank, supra note 363, at 4-7.

\textsuperscript{370} Cf. Dixit & Skeath, supra note 219, at 312 (apparent irrationality is strategically rational when the credibility of a threat is in question).


\textsuperscript{372} For an insightful discussion of how politicians change the minds of others see Howard Gardner, Changing Minds 69-89 (2004) (different techniques politicians use to effect change of mind in diverse populations).
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A legislative threat that aims to change the behavior of a single firm is rather an exception, certainly not a commonplace scenario. For in most cases, threats are directed towards numerous entities, including businesses in a specific industry (e.g., automakers, computer manufacturers); firms of a particular status (e.g., publicly-traded companies); participants in a given market (e.g., commercial landlords and tenants); organizations operating in a certain sector (e.g., universities, institutional investors); participants in specific activities (e.g., professional baseball players); and members of a certain profession (e.g., physicians, bankers). For the purpose of this analysis, I refer to any such pool as a group of threat-recipients. While some groups are homogenous, others are heterogeneous (e.g., firms of different size, different investment horizons). And, while some groups are organized (e.g., trade associations, industrial alliances, labor unions), in others group members may act in an uncoordinated fashion. In addition, groups may vary in size, ranging from a mere few members (as in an oligopoly) to several hundreds and beyond (as in a profession).

In order to better understand the inducement effect of legislative threats on behavior, the analysis focuses on the effects on compliance of strategic interaction within organized and unorganized, homogeneous and heterogeneous groups. Common to all these situations, is that the legislator threatens to pass an unfavorable legislation unless all members of the group comply with his demands.373 Anything short of group-wide compliance will result in the threat being exercised.374 The latter condition presupposes that the legislator is able by himself—or through an agent—to

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373 Theoretically, the legislator may condition the threat on compliance by any predetermined share of the group members (e.g., 80 per cent of the group members). In order to make this threat operative, however, the legislator must be able to determine which entity has complied and which has not. Yet, in these cases, compliance with the legislator’s demands is in essence a form of public good because sufficient compliance will avert the risk of legislation, a result that will benefit all the members of the group (who cannot be excluded from receiving that benefit). Absent effective in-group enforcement mechanisms, widespread free-riding may defeat compliance altogether and make the group and the legislator worse-off. See, e.g., Matthias Cinyabuguma et al., Cooperation under the Threat of Expulsion in a Public Goods Experiment, 89 J. PUBL. ECON. 1421 (2005) (member participation increases significantly when threatened by expulsion or ostracism).

374 Imposing this strict condition makes good game-theoretic sense: if the legislator has ex post discretion to take account of how many entities complied with the demands before determining to carry out the threat, salami tactics used by threat recipients will likely defeat the legislator’s attempt to carry out the threat and subvert the threat’s inducement effect altogether. Salami tactics encompass measures that entities may use, such as partial compliance, to whittle down the threat. See Dixit & Skeath, supra note 219, at 315.
discretely observe whether or not group members have complied.375

The strategy a player chooses in equilibrium crucially depends on what one player believes the other player will do in the particular situation. Applying this insight to groups, the best response strategy of any single entity depends on what that entity believes is the legislator’s best response to the behavior of members of the group. In turn, the entity’s belief regarding what the legislator will do depends on what that entity believes is the best response of other entities in the group to what the legislator will do; and so on. In other words, viewed from a single entity’s perspective, the choice of strategy becomes a two-dimensional strategic decision: First, it depends on what the entity believes the legislator will do in response to the behavior of the members of the group; and, second, it depends on what the entity thinks the other entities in the group believe about what the legislator will do in the particular situation, and in turn, on what they will do in response. Hence, the thrust of the argument is that an entity’s compliance or non-compliance (e.g., free-riding, holdout) of other entities in the group. Every entity plays therefore two games: one with the legislator; the other with its group cohorts.

1. Homogeneous Groups

Homogenous groups consist of entities whose interests, insofar as they affect their incentive to comply (or not comply), are identical.376 Entities’ interests are identical when their expected payoffs in the game are the same. Specifically, when the entities are similarly-situated—e.g., market power is equally distributed, all firms are of similar size, all have similar manufacturing capacity—no payoff variability arises. Thus, when equilibrium analysis indicates that compliance with the legislator’s demands is the entity’s best response, compliance will logically also constitute the group’s best response. The latter squarely derives from the fact that the interests being identical: avoiding unfavorable legislation is equally-beneficial to every member in the group.

Having said that, are group members expected to comply given that compliance is in their best interest? As members of the group are mindful of the fact that the legislator will execute the threat unless they comply, the answer to this question crucially depends on the size of the group.

In sufficiently small groups, such as firms in an oligopoly, members may contract with one another, implicitly or explicitly, to ensure that each member complies and that the group as a whole averts the risk of legislation.377 Intra group threats of ostracism or

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375 In one case, the U.K. government appointed a university to monitor compliance on behalf of the government. The university was required to report to the government its assessment of the state of compliance. See Monitoring Proforma for Commercial Leases Code of Practice, supra note 165.

376 That entities, like firms in an industry or members of a profession, may compete against each another on business and market shares does not suggest that their interests, as they relate to compliance, diverge.

377 This applies the notion of a cartel, where each firm abides by the agreed-upon discipline of the cartel because each does better than if each firm acts on its own will. See Kreps, supra note 218, at 74. The only difference, however, is that firms are not confined to implicit contracting (i.e., tacit collusion), which is due to the illegality of cartel agreements.
cross-punishments may guarantee that members abide by their agreements. It is also reasonable to assume that the legislator is capable of telling whether or not the entities have duly complied, thus reinforcing members’ incentives to comply.

As groups grow in size, however, contracting becomes costly and unavoidably impractical. Moreover, collective action problems that inhere in group behavior militate against voluntary group-wide compliance, even though compliance—to the utter exclusion of anything else—is certain to maximize the utility of the members of the group. Whether or not the group is organized therefore becomes a decisive factor: the existence of a representative body, which by virtue of its formal rules (e.g., charter, bylaws), informal rules (e.g., social norms), and resources can impose non-legal sanctions to enforce certain actions, may reduce hold outs and secure group-wide compliance necessary to keep the risk of legislation at bay (that is, provided it functions as it should so as to further the interests of its members). Put differently, because monitoring each entity for compliance is extremely costly and burdensome, the legislator may “delegate” the responsibility to a body that represents the group and enforces compliance on its members. Most often, this representative body will also conduct on behalf of the group regulatory bargaining (in lieu of strict compliance).

Moreover, in a limited set of circumstances compliance may ensue even though a group is not (formally or informally) organized. Specifically, when compliance affects the reputation of members in the group (e.g., for being good corporate citizens), and when members value their reputation, the incentive to comply—in the absence of formal, centralized intra-group enforcement—may be sustained by sanctions imposed by individual members on each other in an attempt to maintain and enhance their reputational capital, thus inducing a reputational cascade. The argument, more precisely, hinges on the fact that non-compliance by one member is, in essence, a negative reputational externality with respect to the remaining members of the group.

What is more, the issuance of a legislative threat (and the advent of collective action problems) often reinforces the tendency of unorganized groups to organize. Indeed,

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379 Of course, this is true except for a Pareto-improving bargaining, which in itself is a form of compliance. Potential Pareto-improving regulatory bargains are discussed and explained in Part III(D) below.
380 See Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Groups (1971) (given collective action problems, public goods are produced at sub-optimal levels, less than what is desirable for the group as a whole).
381 See Laurence R. Iannaccone, Sacrifice and Stigma: Reducing Free-riding in Cults, Communes and Other Collectives, 100 J. POLIT. ECON. 271 (1992) (showing that efficient groups may use stigma in order to reduce free-riding); see also Eric A. Posner, The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action, 63 U. CHI. L. REV. 133, 165-76 (1996) (discussing various sanctions informal groups employ to enforce discipline on group members).
382 Organized groups may also establish a monitoring mechanism in order to keep track of members’ compliance. See, e.g., Monitoring Proforma for Commercial Leases Code of Practice, supra note 165 (the British Property Federation was appointed to monitor implementation on behalf of the property sector).
383 See generally Jackson, supra note 197 (reputation for responsibility and other virtues is a form of capital).
threat-driven effort to organize has been observed in many cases. For example, in response to a threat to legislate stringent recycling requirements, “PC companies ... scrambling to come up with a system that is voluntary but still effective,” joined forces to form the National Electronics Product Stewardship Initiative, a working group designed to develop proper solution.385 Similarly, responding to the government’s threat to legislate cyber security standards, network companies formed an industry-wide group—the National Cyber Security Summit Alliance—to study the problem and devise proper measures. The Alliance, which undertook to deliver initial solutions within a short time,386 was the first step towards averting the risk of legislation.387

Given the important role of organizations in ensuring group-wide compliance (and, as I explain below, in facilitating efficient bargaining), legislators often encourage—in word and in deed—the process of organizing. For example, legislators may do so on an ad hoc basis by convening the targeted entities and thus reducing the transaction costs of organizing.388 Legislators may also provide statutory funding for group participation in congressional committee hearings, thus subsidizing the cost of organizing otherwise-unorganized groups.389 Lifting the cost of organizing makes good sense: organizations may secure group compliance and reduce the cost of bargaining, increasing in turn the legislator’s payoff and enhancing his utility.

Group organization increases the likelihood of group-wide compliance and therefore renders legislative threats more useful in regulating social behavior. The tendency towards organization also reduces the transaction costs of regulatory bargaining (e.g., lower information costs), thereby enabling legislators and industry representatives to negotiate and design superior regulatory measures. In turn, this effect further reinforces the legislator’s incentive to use threats and the group’s impetus to organize. The growing use of legislative threats and the increased probability of repeated threats against certain groups also suggest that repeat threat-recipients will be better-off investing the one-time fixed cost of organization as early as possible.390 On the whole, insofar as legislative threats increase groups’ propensity to organize, the widespread regulatory use of threats may counter social and economic processes that contributed to the gradual weakening and disintegration of organizations.391

385 See Harrison, supra note 155.
387 Id. (the Alliance created a public-private regulatory partnership).
388 Having threatened legislation to impose cyber security standards, federal lawmakers convened 350 computer executives at the government-sponsored National Cyber Security Summit. See Markhoff, supra note 120, at C8. In response, the industry formed the National Cyber Security Summit Alliance.
390 The costs of organization are akin to start-up costs. “Once they are borne, they do not affect marginal costs [and] [g]roups that have already borne these start-up costs ... will have a comparative advantage” in ensuring compliance, in fending off the risk of legislation, and in shaping the regulatory environment in which they operate. See Robert E. McCormick & Robert D. Tollison, Politicians, Legislation, and the Economy: An Inquiry into the Interest-group Theory of Government 17 (1981).
2. Heterogeneous Groups

Groups qualify as heterogeneous when the effects of legislative threats on entities in the pool are not uniform. Asymmetric payoffs may be driven by a variety of factors. When a threat is directed to an industrial sector, smaller firms may suffer more onerous consequences than larger firms: if compliance requires investment of a fixed expenditure (e.g., to purchase a new technology), smaller firms—which benefit from lower economies of scale and incur higher costs of capital—may find this expenditure economically-unfeasible.\textsuperscript{392} Here, compliance may force relatively small firms out of the market (and so will the legislation). In other cases, however, smaller firms may be better-situated to comply with the threat. This is likely when switching costs (\textit{i.e.}, the cost of switching from one regulatory regime to another) increase with firm size.

Moreover, payoff differences may arise from the firm’s position in the market. When a threat attempts to eliminate barriers to entry and make a market more competitive, a dominant firm that enjoys quasi-monopolistic rents will suffer harsher consequences than a laggard firm operating on the fringe of the market.\textsuperscript{393} Furthermore, difference in the legal status of entities may also produce payoff disparities, as when the threatened legislation brings to an end the valuable SRO status of several entities in the pool.\textsuperscript{394} Differences in attitudes towards risk and in risk-bearing capabilities may similarly produce payoff variations. In addition, differences in entities’ investment horizons and discount factors may also affect their perception of the game’s payoffs.

In light of the foregoing, the question is whether or not members can be expected to comply and if so, under what conditions? As the entities know that the legislator will execute the threat unless they all comply, they may opt to use compliance and non-compliance strategically in order to shape the regulatory environment in which they and their existing and potential rivals operate; to strategically impose cost on rivals or to reduce their profits; and to improve their ultimate position in the market. Ultimately, whether or not group members comply depends on: (i) the size of the group; (ii) the group composition and the distribution of economic power within the group; and (iii) the availability of enforcement mechanisms to unify members behind one position (whose availability and use is also affected by distribution of economic power).

When a group is relatively small, members can contract to ensure compliance. Often, the group may negotiate a regulatory deal with the legislator, in lieu of strict compliance. Yet, unequal distribution of economic power may shape the bargaining process and ultimately take its toll: the negotiated measures may create an uneven, anti-competitive playing field.\textsuperscript{395} Demonstrating this concern, it is reported that “ISPs are

\textsuperscript{392} The model assumes that the (direct) costs of compliance are fixed (5), because their magnitude does do not change across firms \textit{(e.g., installing technology costs the same irrespective of firm-specific characteristics).}

\textsuperscript{393} See McDowall, supra note 211 (“\textit{T}hreat of legislation may be required to elicit changes” that enhance competition in U.K. payment systems).

\textsuperscript{394} \textit{Cf.} Prynn, supra note 246 (reporting a legislative threat that in addition to imposing stringent standards of conduct will, with respect to Lloyd’s, end its jealousely guarded self-regulatory status).

\textsuperscript{395} See \textit{Voluntary Codes: A Guide for their Development and Use, CANADA OFFICE OF CONSUMER AFFAIRS} 6 (1998),
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concerned [that the threat-induced negotiated code of practice will be] carefully structured as a ‘balanced team,’ ... giving neither dominance to the big players nor the small ones an influence disproportionate to their size.” In contrast, larger groups—for which contracting is not a viable option—may employ various enforcement mechanisms, similar to those discussed above, in an attempt to guarantee compliance and ensure that the risk of legislation is dissuaded.

In the absence of effective enforcement mechanisms, however, compliance and non-compliance may be used strategically as a tool to promote members’ idiosyncratic interests. Hence, while in some circumstances strategic interaction within groups may undermine compliance, in certain others it may counter-intuitively reinforce compliance. For example, an incumbent firm may engage in predatory compliance, wherein the incumbent complies in order to lower market prices and drive rivals out of the market. Compliance may lower the price when, for example, the legislator’s demands are designed to increases competition in the market. Alternatively, a dominant firm may engage in predatory non-compliance so as to prompt the adverse legislation and raise rivals’ costs, ultimately hoping to snatch their market shares and crowd-out active firms from the market. An incumbent firm may do the same in an attempt to deter entry of potential rivals. Rationally, the firm may be willing to suffer the long-term negative impact of the unfavorable legislation (as well as the short-term negative returns associated with the risk of legislation) because these costs are outweighed by the long-term gains from entry deterrence. Lastly, when compliance requires cooperation between two or more sectors—as when in order to ward off the threat of legislation, Silicon Valley technology firms and Hollywood entertainment firms needed to agree on a standard to stop digital piracy—one sector may strategically delay compliance or even avoid compliance altogether so as to increase the risk of potential harm for the other party and improve its bargaining position.

D. Bargaining in the Shadow of Legislative Threats: The Effects of Threats on Transaction Costs and Contractual Efficiency

Compliance with legislative threats is, in essence, a form of implicit and informal


396 See Bell, supra note 190.

397 See McDowall, supra note 211 (legislative threat intended to enhance competition in payment systems).

398 See Carlton & Perloff, supra note 183, at 353-57.

399 Research confirms that established firms in an industry can affect the disadvantages facing potential entrants, the magnitude of entry costs, and the existence of entry barriers. See Kofi O. Nti & Martin Shubik, Noncooperative Oligopoly with Entry, 24 J. ECON. THEORY 187 (1981) (discussing strategic behavior designed to erect entry barriers).

400 See Bill would Prevent Sharing of Digital Music, Video, supra note 136; see also Boliek, Lawmakers Push Fast-forward to Settle DVD Dispute, supra note 140 (compliance required cooperation needed between the Directors Guild of America, a representative body of directors and film studios, and a Utah-based DVD manufacturer that edited-out profanity, violence, and foul language from films).

401 See, e.g., Jameson, supra note 164 (“The deadlock is being blamed on some of the UK’s major retailers. ... It’s clear that they would like to see intervention. It’s hard to see any basis for agreement now”).
political transaction, in which the legislator barters the non-use of legislative power with respect to a particular issue in return for the firm’s commitment to change its conduct. Drawing the attention to this aspect, game theorist Thomas Schelling observed that “[t]o study the strategy of conflict is to take the view that most conflict situations are essentially bargaining situations.” But bargaining in the shadow of legislative threats is often far more explicit and formal, such as where legislators and firms convene (e.g., in committee hearings), negotiate the terms, and devise possible solutions to address the specific social concerns towards which the threat was directed in the first place.

Focusing on this bargaining process spotlights two important effects of legislative threats. The present discussion advances two interrelated propositions pertaining, respectively, to the transaction costs associated with that bargaining and to the efficiency of the negotiated measure. Specifically, the first proposition concentrates on the effect of legislative threats on reducing transaction costs and, in turn, on facilitating “regulatory” bargaining with the legislator (or regulator) in the shadow of the threat. Building on this insight, the second proposition highlights the functional and welfare superiority of the negotiated measure in dealing with the policy concern to which the legislator directed the legislative threat initially.

The earlier analysis established that, where the probability that the threatened legislation will be enacted into law is sufficiently high, credible legislative threats will induce the firm to comply with the demands that the legislator has presented, whatever these happen to be. Viewed from the firm’s perspective, the inducement effect of legislative threats provides strong economic incentives, thus leading the firm to reform its conduct so as to bring it in line with the legislator’s demands. In other words, facing the threatened negative consequences of coercive regulatory intervention, compliance inexorably becomes the firm’s rational best response. Nevertheless, incurring the cost of compliance qualifies as the firm’s best response only insofar as there is no other way in which the firm can address the legislator’s demands or respond to the underlying policy concern more efficiently.

Lo and behold, other options certainly exist. In particular, bargaining with the legislator or other social planners enables the firm to explore, negotiate, and agree on

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402 See Thomas C. Schelling, *The Strategy of Conflict* 5 (1963) (“conflict situations … are situations in which the ability of one participant to gain his ends is dependent to an important degree on the choices or decisions that the other participant will make. … The bargaining … may involve threats of damage”). See also John F. Nash, Jr., *The Bargaining Problem*, in *ESSAYS ON GAME THEORY* 1-8 (1996) (bargaining is a non-zero two-person game).

403 See, e.g., Dave Sheinin, *Pro Sports Leagues Pitch Steroids Proposals on Hill; Plans Touted as Better than Fed Policy*, THE WASH. POST, May 19, 2005, at D01 (“Faced with the increasing threat of legislative action from Congress, the leaders of four of the nation’s major professional sports leagues touted their steroids testing programs” while bargaining with legislators in a hearing before the House Commerce subcommittee).

404 This statement captures predictions that are based on the credible threat compliance equilibrium.

405 The negative impact of lenient, moderate, and severe threatened legislation is 10, 20, and 30, respectively. The magnitude of these costs increases with the severity of the threatened legislation.

406 The cost of compliance is fixed at 5 because the demands that the firm changes its conduct and policies remain unchanged irrespective of the level of severity of the threatened legislation.
cost-effective, self-regulatory measures. Compared with the fixed cost of complying with the legislator’s demands for reform, any measure that reduces this cost or that further increases the benefit to the firm (i.e., beyond the benefit of strictly averting the threatened legislation\textsuperscript{407}), and which can be achieved through bargaining clearly makes the latter the best response strategy from the firm’s profit-maximizing perspective.

The legislative threat shapes the relative bargaining powers of the respective parties, leaving the power in the hands of the legislator.\textsuperscript{408} Moreover, because exercising the threat provides the legislator with a credible fall-back option, transaction costs of bargaining are expected to be kept to a bare minimum. Reducing the magnitude of transaction costs—including, but not limited to, exchanging information, projecting, negotiating, and drafting—facilitates bargaining and, presumably, ensures that the bargaining is more likely to produce efficient measures.\textsuperscript{409} In that respect, lowering transaction costs enables the parties to negotiate specific and long-term social control arrangements, thus increasing the durability of such agreements and eliminating in turn much of the deadweight transaction costs of dickering in the future.\textsuperscript{410}

Even more, given the impending threat on the one hand and the expected efficiency gains from bargaining on the other, the firm is strongly motivated to pursue the bargaining option; share with the legislator sufficient information that is necessary to remove otherwise existing asymmetries; devise mutually-beneficial measures; and ultimately enter into a voluntary, threat-induced agreement. In that respect, threats serve as an information-revelation mechanism, which remedies the legislator’s inability to obtain this information directly.

Legislative threats may also facilitate cooperation between the targeted entities.\textsuperscript{411} Applied to professions and industrial sectors, the use of legislative threats provides strong incentives to organize in groups. Legislative threats may therefore reinforce

\textsuperscript{407} Averting the risk of the threatened legislation is desirable because, in addition to the superior cost-effectiveness of self-regulation, it reduces uncertainty about the firm’s future business, which lowers returns on equity, increases price volatility, and raises the firm’s cost of capital. For further discussion of the effects of risk of legislation see Beck \textit{et al.}, supra note 204 (potential adverse legislation negatively affects the stock prices of firms covered by legislation); and Ferguson & White, supra note 242 (the “Congressional Effect” shows that stock returns are lower and stock price volatility is higher when Congress is in session, consistent with the hypothesis that firms face a more uncertain regulatory environment legislative activity is under way).


\textsuperscript{410} In other words, higher contractual durability reduces the likelihood and cost of renegotiation that may be necessary to revise the agreement when the circumstances change in the future.

\textsuperscript{411} See, e.g., Mr Baker Gets Tough, \textit{The Times}, Nov. 1, 1986 (“[T]he threat of legislation to restructure the [teaching] profession will concentrate minds wonderfully when unions and employers meet”); Unions See Signs of Breakthrough in Consultation Law, 3 EURO. REV. 3 (Sept. 1998), at http://www.tueip.dircon.co.uk/er3-page3.html (a legislative threat is necessary to bring a party to the negotiating table).
groups’ tendency to organize. Specifically, these economic incentives force industry participants to organize, cooperate (e.g., minimize holdouts), and share information that the legislator or other social planners would not have otherwise obtained because, presumably, organizing and sharing such information increases the likelihood of reaching an efficient agreement and consequently makes these entities better-off. Moreover, industry-wide information is particularly valuable because it aggregates firm-specific information (e.g., instances and preferences related to numerous firms in the group), thus reducing potential errors in designing reform measures.

Viewed from another perspective, lowering transaction costs decreases the degree of **contractual incompleteness**. Where transaction costs are low, the parties are better positioned to (i) think ahead and plan for various contingencies that may arise; (ii) negotiate about these plans and devise proper measures; and (iii) write the contract in clear, unambiguous language that leaves little room for vagueness and uncertainty. Conceivably, drafting the firm’s contractual obligations in clear, unambiguous language makes it easier for the legislator to monitor the firm’s performance, ensure that it stands by its contractual obligations, and deter possible breaches, the result of which will be reinstatement of the threat of legislation. In other words, low transaction costs reduce **ex post “enforcement” costs**. Lastly, lowering contractual incompleteness also decreases the likelihood of future revisions and renegotiations, which reduces in turn the level of uncertainty. And, when uncertainty about the future is lower, the firm is better positioned to make long-term investments in self-regulatory reforms.

Notably, by issuing a credible threat, the legislator implicitly pledges to address the social concerns affected by the conduct towards which the threat is directed. The legislator thus promises to undertake actions needed to induce the firm to comply or, if necessary, to carry out the threat to legislate. Against this backdrop, bargaining makes the legislator, too, better-off for it enables the parties to flexibly explore various measures and choose those that maximize their mutual gains. More specifically, as

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412 While organizing is certainly not cost-free, it has substantial effect on reducing the transaction costs of bargaining with the legislator and, therefore, on increasing the likelihood and efficiency of the negotiated measures. Cf. George J. Stigler, The Theory of Economic Regulation, 2 Bell J. Econ. 3 (1971) (transaction costs of regulatory bargaining include, but are not limited to, the costs of organizing).

413 The notion of incomplete contracts captures the idea that contracting is a costly process in and of itself, and that this cost affects the ultimate features, scope, precision, and quality of the contract. See Oliver Hart, Firms, Contracts, and Financial Structure 21-24 (1995) (discussing different sources of contracting costs and the inevitable contractual incompleteness for which contracts may contain gaps, are missing certain provisions, and are silent about the parties’ obligations in some future circumstances).

414 Cf. Negotiated or Voluntary Agreements, ENVIRONMENT AGENCY, at http://www.environment-agency.gov.uk (Jan. 1, 2004) (“The regulator may be involved in monitoring progress, especially if regulatory action will be taken if the voluntary agreement fails to deliver the required improvement”).

415 In other words, re-issuing the threat or, in some cases, carrying out the threat ensures that firms do not neglect their contractual obligations. See Winter, supra note 277, at A14 (Representative McKeon, who issued a legislative threat in an attempt to curb tuition increases, “warned he would restore the bill’s penalties if universities appeared to slack off in their efforts to curb costs”).

416 Cf. Mosquera, supra note 132 (reporting that industry groups told lawmakers that “sweeping regulations governing the collection and use of data” are not necessary).
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legislative threats elicit firm- and industry-specific information, bargaining provides an opportunity to tailor the best practicable reform measures to achieve the social interest in question.418 Thus, bargaining is preferable from the legislator’s perspective because the negotiated measures can improve upon the legislator’s initial demands for reform,419 correct market inefficiencies,420 achieve cost-effective social control, better allocate scarce resources, and maximize social welfare.421 It turns out that bargaining may produce social control measures that are not only Pareto superior to the threatened legislation and the legislator’s demands but that may also approach the Pareto frontier.422 Certainly, doing that is expected to increase the legislator’s rewards for securing and optimizing the given policy reform.423

IV. LEGISLATION VS. THE THREATS OF LEGISLATION: FUNCTIONAL AND INSTITUTIONAL DIMENSIONS

Having examined the concept, pervasive use, and economic underpinnings of legislative threats, I presently focus on differences between formal legislative measures and informal legislative threats, as alternatives means of social control. This choice entails functional and institutional considerations pertaining, respectively, to the comparative capacity of legislative threats to effectively control behavior in an increasingly-complex social reality; and to various political, constitutional, and democratic implications arising from the use of legislative threats. Highlighting these considerations not only advances the understanding of the phenomenon, but is also essential to evaluating on normative grounds the ubiquitous use of legislative threats and to assessing their social welfare implications against explicit normative criteria, to which I return in Part V.

A. Functional Dimensions

Legislators and regulators confront the overwhelming responsibility for maintaining order and effecting social control in an increasingly complex and dynamic

418 Moreover, given imperfect information as to the level of severity of the threatened legislation, the firm is likely to reveal information it would not have otherwise shared if it were to be perfectly informed.

419 The benefit for the legislator from inducing a firm to comply with the legislator’s initial demands and abandon its undesirable practices is 5. Bargaining with the legislator may result in higher benefits, however.

420 Indeed, the chief objective of regulatory measures (whether super-imposed or induced by threats) is to eliminate market inefficiencies and promote efficiency. See Carlton & Perloff, supra note 183, at 652.


422 The Pareto criterion of efficiency provides an analytic standard for ranking different results according to their effect on utility. Resources are allocated in a Pareto-optimal fashion—and are therefore located on the Pareto frontier—if and only if any further reallocation can enhance the utility of one person only at the expense of another. Thus, an allocation of resources is Pareto-superior to an alternative allocation if and only if no one is made worse-off by the allocation and the utility of at least one person is improved. See Jules Coleman, Efficiency, Utility, and Wealth Maximization, in MARKETS, MORALS, AND THE LAW 95-132 (1988).

423 Research in political economy confirms that constituents and political contributors reward effort that legislators put to advancing desirable policies and good reputation but penalize failures and bad reputation.
society. In the process, they are called upon and expected to succeed in dealing with numerous rather insurmountable challenges, such as highly limited data or, alas, a wealth of unorganized information; inability to accurately assess risks and predict future outcomes; insufficient understanding of relevant economic processes, scientific relationships, and technological methods; rapidly changing social circumstances and bewildering behavioral patterns; and, above all, a lack of time and resources. These severe limitations explain the failure of the legal system in many areas of public policy and highlight its severe shortcomings as a social governance mechanism.

Reinforcing one another, these problems permeate highly complex legal rules that render government intervention virtually inefficacious. For example, whereas legislators attempt to promote expansive programs for cleaning up the environment or for increasing job safety, the legislative measures they devise to implement these programs are so convoluted that results are unlikely to be delivered. The increased complexity of legal rules—which, inevitably, increases uncertainty—and the consistent failure of legal intervention to advance social goals has fueled the interest in sweeping reforms, thus casting doubt over conventional methods of social control.

Against this background, I argue that legislative threats can and should be viewed as an inevitable measure that emerged in response to the systemic limitations of lawmakers and the inherent limits of the law. Indeed, the regulatory virtues of legislative threats become apparent when juxtaposed with the severe limitations of legislators that impede their capacity to discharge social control responsibilities. In that respect, legislative threats echo Derek Bok’s detailed observations indicating that in many areas governmental intervention is not only ineffective, but often makes matters

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424 See Breyer, Breaking the Vicious Circle, supra note 118, at 42-43 (“Predicting risk is a scientifically related enterprise, but it does not involve scientists doing what they do best, namely developing theories about how x responds to y, other things being equal. Rather, it asks for predictions of events in a world where the ‘other things’ include many potentially relevant, rapidly changing circumstances, requiring the expertise of many different disciplines to reach a conclusion”).

425 For example, “[a] waste site evaluation ... may require knowledge of toxicology, epidemiology, meteorology, hydrology, engineering, public health, transportation, and civil defense, disciplines with different histories, different methods of proceedings, and different basic assumptions.” See Breyer, Breaking the Vicious Circle, supra note 118, at 42-43.

426 The overwhelmingly high demands on legislators’ time are well-documented. See, e.g., Bauer et al., supra note 248, at 408-413. Time constraints affect the work of Committee members as well. See Perkins, supra note 248, at 378-79 (two-thirds of the House Judiciary Committee members hardly participate in regular meetings).


428 See Epstein, Simple Rules, supra note 391, at 16, 21-36 (documenting the massive increase in complexity of rules that govern society and advocating a greater reliance on simple rules: “[T]he increasing complexity of legal rules[is] a rough sign that something has gone badly astray”).


430 See Schuck, The Limits of Law: Essays on Democratic Governance, supra note 428, at 9 (“Meant to increase certainty, regulation actually reduced it on balance because of its great ambition”).

431 See Bok, supra note 430, at 129-131, 411 (discussing, respectively, the costs and benefits of environmental and healthcare legislation suggesting that government intervention is ineffective).
In fact, compared with formal legislative measures (e.g., command-and-control statutes and regulations that command the use of specified technologies or processes that legislators and regulators believe will achieve social goals), legislative threats offer a qualitatively different approach for guiding and controlling social behavior, even if highly complex. As I demonstrate below, legislative threats are often functionally superior in achieving predetermined policy objectives and in advancing national interests. The superior regulatory capacity of legislative threats arises from its capacity to shift social control responsibility to the regulated entities; to alleviate the information shortcomings of lawmakers; to rapidly and flexibly accommodate the changing demands of social control; and to economize on the significant spending necessary to shoulder the social cost of law enforcement. Taken together, these features suggest that legislative threats are well-positioned to deal with the increased complexity of social activities.

1. Information: Asymmetrically Informed Social Planners

Legislation and regulation are data-intensive undertakings, for in order to devise effective measures of social control lawmakers must possess and process significant amount of information concerning the nature of the targeted conduct, the scope and sources of the problem, and the range of possible solutions. Advanced scientific research indicates the relevancy of ever more data, further increasing the information demands of social control. Furthermore, as the regulated activities become increasingly more complex, the amount of data necessary to effect social control increases as well. Absent sufficient and credible information, the legislative measure will rest precariously upon unrealistic assumptions, thus creating the risk of unintended economic consequences, possibly making matters worse. Predictably, “uncertainties, knowledge gaps, default assumptions, guesses … spell trouble.”

These information prerequisites notwithstanding, lawmakers ordinarily face highly limited data or a wealth of unorganized information, which is costly or virtually impossible to process. Hence, the central problem undermining any attempt to set

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433 Reinforcing the demand for information, legal doctrine provides that science-based regulations adopted by administrative agencies are subject to judicial review, where courts can exercise the authority to question the sufficiency and credibility of scientific information the agency relied upon to promulgate its rules. See Sheila Jasanoff, *Science at the Bar: Law, Science, and Technology in America* 69-78 (1995).

434 See Higbee, supra note 162, (the government admitted that the threatened legislation which would have enacted minimum safeguards to protect the interests of business tenants, could have unintended side-effects affecting the complex commercial property market); Mosquera, supra note 132 (the “legislation may have unintended consequences, such as pushing prices higher and creating fewer choices).

435 Absent sufficient information, even benevolent intervention can makes things worse and should be viewed with skepticism. See George Stigler, *Public Regulation of the Securities Market*, 37 J. BUSINESS 117 (1964).

efficient standards and devise effective measures of social control is the gathering and processing of necessary information because “[m]ost of the scientific information needed [is found] in the hands of the industry to be regulated.” 437 Moreover, while the regulated entities hold the information, they normally assert attempt to prevent its disclosure on the grounds of confidential business information or, alternatively, use it to tilt the legislative or administrative rule-making process in their favor. Legislators, it seems fair to say, are asymmetrically and imperfectly informed about the very activities they seek to regulate. Of course, legislators and regulators may attempt to gather the relevant information, but that may prove to extremely costly. Irrespective of the cost of information, however, data-gathering processes—including, but not limited to, in-house research, testimonies, scientific studies and independent expert opinions, and public comments—cannot guarantee that lawmakers receive sufficient and credible information for a variety of other reasons. For instance, the information received may be incomplete or tainted by bias, self-interest, or lack of expertise. 438 Moreover, scientists may hesitate to publicly state conclusions that are not premised on scientifically-accepted evidence.

Strategic reliance upon legislative threats, however, lessens the scope of information asymmetry. First, legislative threats elicit information from threat-recipients, thus remedying the legislators’ inability to obtain the necessary information directly and cost-effectively. Given the impending threat, firms are strongly motivated to share with the legislator sufficient information that he would not have otherwise obtained, and use that information to negotiate and devise mutually-beneficial measures. The incentive to reveal information is further reinforced because sharing such information increases the likelihood of reaching an efficient regulatory agreement. Second, reliance upon legislative threats to induce social change and implement a desired policy requires substantially less information than what is necessary to legislating standards of conduct. Internalizing the “regulatory” responsibility to targeted entities that possess pertinent information, threat-induced self-regulation alleviates the information burden that the legislator would have otherwise faced.

Lastly, the use of legislative threats not only reduces information asymmetries but it also improves the amount and accuracy of information which is used in turn to devise policy measures. As I have explained, legislative threats provide threat-recipients with strong incentives to divulge relevant information and reveal their preferences. Directed towards groups (e.g., industrial sectors), threats are expected to elicit information from numerous threat-recipients (e.g., firms), thus providing the legislator with a wealth of

437 Id. at 109-112.

438 “Developing information within the agency avoids the taint of industry self-interest, but the agency may lack the requisite technical ability. … [The agency’s staff was] able to develop models based upon existing industry-wide statistical information, but they lacked firm-specific information. They could not determine how a particular standard (applied to an individual firm) would affect that firm’s costs or fuel economy.” See Breyer, Regulation and its Reform, supra note 437, at 110-111 (observing that experts who could have provided the necessary scientific and technical information are often with the industry and that using adversary proceedings to gather information from a hostile industry often proves very difficult and inefficient).
industry-wide data and aggregate firm-specific information. Statistically, as the legislator receives more information about more firms (i.e., a larger sample comprising more variables), the risk of error decreases and the accuracy of information increases, thus ensuring more efficient policy measures.\(^{439}\) Moreover, extracting firm-specific information can also be viewed as a form of social control experimentation, wherein an attempt is made to draw conclusions (relating, for example, to dealing with certain problems) from the manifold experiences of individual firms. In these circumstances, the legislator “serves as information clearinghouse of successful strategies.”\(^ {440}\) Along the same lines, Derek Bok has insightfully noted that “[w]ith thousands of separate initiatives scattered across the country … government agencies [should] adopt the best practices of others.”\(^ {441}\)

2. **Adaptability: The Superiority of Threat-induced Self-regulation of Conduct**

There is hardly any doubt that “Congress is not institutionally well suited to write detailed regulatory instructions that will work effectively.”\(^ {442}\) This concern is similarly valid with respect to the numerous regulatory agencies to which Congress has delegated rule-making power.\(^ {443}\) For, in addition to information asymmetries and incompleteness, legislators lack the expertise, acumen, time, and finesse necessary to devise cost-effective measures and set rational standards of conduct.\(^ {444}\) A statement made by a U.K. Member of Parliament, “I am opposed to imposing fresh rules, and in particular I believe you cannot legislate for common sense,”\(^ {445}\) plainly illustrates these shortcomings. Even more, highlighting the lawmaker’s tunnel vision and inherent inability to consider related problems that may benefit from a unified approach, Woodrow Wilson observed that “the task of the legislator to embrace in his view the whole system, to adjust his rules so that the play of the civil institutions shall not alter

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\(^ {439}\) The *law of large numbers* supports this point: where individual members of a group are subject to idiosyncratic differences, the average behavior of the group is more predictable than that of individual members. This tendency increases with the size of the group. *See Law of large numbers*, in Black, supra note 50, at 265. Hence, the larger the sample size and the lower the standard error, the more reliable the information is.

\(^ {440}\) *See Lucent Technologies Signs Voluntary Agreement with EPA*, supra note 159.

\(^ {441}\) *Cf.* Bok, supra note 430, at 414 (“One advantage of our federal system … is the scope it offers for experimentation and innovation. With its great size, decentralization, and respect for individual effort, America offers fertile ground for new ideas. No nation is better at devising ingenious solutions to problems”).

\(^ {442}\) *See Breyer, Breaking the Vicious Circle*, supra note 118, at 42. *See also* John V. Tunney, *The Federal Legislative Process: Misinformation, Reaction, and Excessive Delegation*, 7 ENVTL. L. 499 (1977) (major regulatory efforts between 1962 and 1976 responded to perceived crises, paid hardly no attention to cost-benefit analysis of regulation, and were voted on by members of Congress who did not know what they were voting on).

\(^ {443}\) *See Breyer, Regulation and its Reform*, supra note 437, at 109-119 (highlighting problems inherent in the regulatory process, such as deficient data, lack of coordination with other agencies, and unintended effects).

\(^ {444}\) “Only painstaking and continuous study can give a legislator command of the often complex details of any one of the many proposed pieces of legislation. [T]he best-informed of our lawmakers are fully acquainted with only a fraction of the bills that come before each session.” *See Bauer et al.*, supra note 248, at 412. Committee members are also minimally present. *See Perkins, supra note 248, at 378-79* (two-thirds of House Judiciary Committee members hardly participate in the committee’s deliberations).

\(^ {445}\) *See Hamilton, supra note 146* (legislator reluctant to impose intrusive D&O compensation standards).
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the play of the economic forces, requires more training and more acumen.” 446

Nowadays, policy issues become increasingly more complex, posing in turn formidable challenges the solution of which frequently requires ingenuity and innovation. In response to the government’s concern over cyber attacks, for example, Microsoft’s Chief Security Strategist noted that “the government plan was short on specifics [and] acknowledged that many of the challenges industry and government face would take years to address.” 447 Yet, because lawmakers are not capable of competently handling such matters, unilateral regulatory measures are not up to the task. 448 The manifold failings of “top down” policy measures are particularly relevant to the U.S. regulatory system which, unlike many industrialized nations, invariably acts through formal lawmaking proceedings, thus limiting the extent to which companies, unions, and other interested parties can participate in the lawmaking process. 449 Furthermore, owing to the abrasive modus operandi in the U.S. regulatory sphere, statutes and regulations are less likely to take account of the specific circumstances of the regulated entities, thus increasing compliance costs and weakening the incentives to comply. 450

Given differences in the capacity and availability of resources, it seems that firms, not legislators, are better-situated to regulate themselves (assuming they properly account for potential externalities). 451 Thus, by inducing compliance with the legislator’s objectives, and by internalizing (to the firm) the responsibility to tailor firm-specific measures most useful to achieve these goals, legislative threats harness these functional advantages. 452 Moreover, firms possess regulatory expertise that legislators are lacking (but do not enjoy similar economies of scale in devising rules of conduct 453). Compared with formal legislation, threat-induced self-regulation is therefore functionally superior in dealing with increasingly-complex and data-intensive policy

446 See Wilson, supra note 217.

447 See Markhoff, supra note 120 (reporting the government’s concern over cyber attacks) (emphasis added).

448 Homeland Security Department officials are reported to have said that “the federal government will back away from issuing new security mandates to industry, and instead let private companies take the lead [because] [w]e cannot secure the homeland from Washington, D.C.” See Chris Strohm, Homeland Security Looks to Industry to Secure Nation’s Infrastructure, GOVEXEC.COM, Jan. 12, 2004, at http://www.govexec.com (internal quotation marks omitted).

449 See Bok, supra note 430, at 415. In Bok’s view, “[i]t [s]hould be more efficient and less contentious for the parties to present their interests to officials who are not intimately familiar with the conditions of the firms they seek to regulate.” Id. Pointing to some sources of inefficiency, Bok states that “[i]n such an atmosphere, … rule-making is highly contentious, … generates widespread dissatisfaction, while costing so much money that the government can attend to only a fraction of the problems subject to its jurisdiction.” Id.

450 Id.

451 For a discussion of the functional advantages of self-regulation see Part I(B) above.

452 Given that policy measures are essentially public goods, the responsibility for devising policies should rest with the party that values them the most. Cf. Timothy Besley & Maitreesh Ghatak, Government versus Private Ownership of Public Goods, 116 Q.J. ECON. 1343 (2001) (documenting the change in the division of responsibility between the state and the private sector for the delivery of public goods with an increasing trend towards contracting out to the private sector and public-private partnerships, and arguing that if contracts are incomplete then ownership of a public good should lie with a party that values the benefits relatively more).

453 See Douglass C. North, Structure and Change in Economic History 27 (1981) (“The economies of scale associated with devising a system of law, justice, and defense are the basic underlying source of civilization”).
concerns, thus providing the sought-after panacea. In keeping with the previous point, research shows that, compared with the state, securities exchanges are better-positioned, have stronger incentives, and therefore more likely to devise optimal regulations that minimize the cost of regulation and maximize the benefits from investor protection and prevention of abuses in securities markets.

Using threats to induce a change of conduct is advantageous for at least three other reasons. First, depending on the particular stakes, the inducement effect of legislative threats may spur firm-specific and industry-wide investment in R&D insofar as such investment may produce cost-effective compliance measures. The impending threat provides the firm with strong incentives to make investment, ensuring in turn inventive solutions and higher regulatory efficiency. Indeed, “experience tells that the threat of legislation is the best way to stimulate real improvements and technological innovations.”

Second, compared with intrusive formal legislation, market-driven solutions prompted by threats run a lower risk of unintended and therefore undesirable consequences, and avoid legislative spill-over that results from the fact that legislation cannot be made sufficiently targeted. Government intervention in the provision of health care demonstrates the potential for such damaging consequences: “Congress [veered] from market-oriented remedies, such as encouraging health maintenance organizations, to regulatory solutions, such as mandatory fee schedules for doctors,” the result of which was “40 million Americans without health insurance but enough government intervention to push up physicians’ fees.”

Third, the use of legislative threats facilitates a cooperative, bilateral regulatory process. Compared with formal

454 The FCC’s regulatory threat directed to the media industry in an attempt to halt unauthorized sharing of copyrighted digital content “represents new government pressure for industry groups to create [a] system on their own for digital rights management.” See Chiger, supra note 134.


456 It is precisely to that end that PC manufacturers joined forces and formed the National Electronics Product Stewardship Initiative, a working group designed to develop solutions to the recycling problems of hazardous materials. See Harrison, supra note 155 (“PC makers say a voluntary approach gives them more opportunity to find marketable ways to turn their industry green”).

457 In response to the threat to legislate cyber security standards, four major business associations formed an industry-wide group, the National Cyber Security Summit Alliance, to study the problem and devise measures to reduce vulnerability. See Markhoff, supra note 120, at C8. Microsoft, through its Chief Security Strategist, led the most important working group in charge of putting together necessary technological measures. Id.

458 See Edwards, supra note 161 (legislative threat directed to auto manufacturers to reduce air-pollution).

459 See Mosquera, supra note 132 (“legislation may have unintended consequences, such as pushing prices higher and creating fewer choices”); see also Louis Kaplow & Steven Shavell, On the Superiority of Corrective Taxes to Quantity Regulation, 4 AM. L. & E. REV. 1, 3-4 (2002) (where the state does not know what the firm’s prevention costs are, including direct expenditures to abate the externality and forgone profits from reduction in output, using quantity regulation makes things worse off because the state cannot prescribe the optimal level of production).


461 See Bok, supra note 430, at 411.

462 See Tobacco White Paper: Action on Smoking and Health ‘Delighted’, at http://www.ash.org.uk (Dec. 10, 1998) (“Introducing a Bill would have caused an almighty fight with both sides [i.e., the hospitality trade and the
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legislative measures, the process of regulatory bargaining, in which lawmakers and regulated entities work together, is better suited to yield constructive regulatory measures. In one case, a Lucent Technologies’ representative stated that “[o]ur collaboration with the EPA will reduce greenhouse gases in a way that makes sense from both a business and an environmental standpoint—without regulation or mandate.”

3. **Elasticity: Accommodating the Rapidly-changing Demands of Social Control**

Legal norms must be adjusted over time (through both revisions and additions) in response to nascent social conditions and emerging behavioral phenomena, so as to address newly-arising public concerns and promote social welfare. In this respect, the use of legislative threats to induce a change in conduct is particularly well-suited to accommodate rapidly-changing social circumstances. Assuming other things remain equal, the capacity of threat-induced self-regulation as well as regulatory bargaining in the shadow of the threat to swiftly conceive new policy measures that account for shifting demands of social control enhances society’s ability to achieve policy objectives.

The comparative flexibility of legislative threats over formal schemes of social control (i.e., state-mandated regulation, self-regulation pursuant to statutory authorization, and regulation through litigation), squarely derives from the informal property of bilateral regulatory bargaining and the internal property of threat-induced self-regulatory on which legislative threats are predicated. The significant reduction in transaction costs of threat-induced bargaining increases the likelihood of timely and well-adapted regulatory measures. Furthermore, coupled with an effective threat, relatively short compliance deadlines induce prompt changes. In one case, Disney Chief Executive Officer, Michael Eisner, commented that the threatened legislation “provide[d] the needed discipline of a deadline for the conclusion of industry negotiations.” Lastly, the ability of the firm to influence a particular measure through bargaining enables it to devise such schemes that minimize the switching costs it incurs in implementing these measures, thereby facilitating a rapid change in conduct.

4. **Enforcement: Economizing on the Social Cost of Law Enforcement**

Enforcing the law on non-law-abiding entities consumes vast resources. Ever more, enforcement costs are particularly high given the increased complexity of legal rules

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463 See Lucent Technologies Signs Voluntary Agreement with EPA, supra note 159.

464 Employing a threat of legislation to coerce public companies to expose boardroom compensation resolutions to shareholders voting, U.K. ministers have reasoned that “[t]hese are matters best left to market forces or, at worst, to codes of practice. Legislation is not flexible enough to keep up with changing trends, as every past Companies Act has soon demonstrated.” See Patience Wheatcroft, Funds Should Vet Boardroom Pay, THE TIMES, Mar. 15, 2001, available at http://www.lexis.com.

465 It is not infrequent that given a credible, impending threat, firms vow to produce “initial deliverables” by a specific date. See News Release: U.S. Businesses Promise Security Plan by March 1, 2004, supra note 124.

466 See Bill would Prevent Sharing of Digital Music, Video, supra note 136 (internal quotation marks omitted).
and the information-intensity of the subject activities. Thus, using legislative threats to control conduct may economize on the direct and indirect costs of law enforcement.

The reduction in direct enforcement costs (e.g., cost of criminal prosecution, civil litigation, and administrative monitoring programs) is twofold: First, inducing negotiated or self-imposed standards of conduct, legislative threats reduce the body of formal law (that would have otherwise been needed) and substitutes it with invisible law, thereby decreasing the volume of litigation and other enforcement actions. Second, effective legislative threats, wherein exercising the threat lurks as a credible fall-back option, instill strong disciplining incentives that ensure self-execution of the standards of conduct. In this respect, drafting the negotiated accord in clear, unambiguous language makes it easier for the legislator to monitor the firm and to ensure that it stands by its promises.467 Along the same lines, continuing the threat of legislation or restoring the threat (that is, where it has been retracted in response to initial compliance) guarantees that firms do not drag their feet in implementing such measures.468 In keeping, Representative McKeon, who issued a legislative threat to curb tuition increases, “warned he would restore the [threatened] penalties if universities appeared to slack off in their efforts to curb costs.”469

The use of legislative threats also reduces indirect enforcement costs. Opting-out of the law enforcement system prevents the social costs due to subversion of justice470 and regulatory capture.471

B. Institutional Dimensions

Institutional considerations, which illuminate the choice between formal legislative measures and informal legislative threats from a different perspective, encompass manifold ways in which, by using legislative threats, legislators evade procedural safeguards, institutional constraints, and substantive controls designed to limit their power to make law and effect policy changes. Importantly, while depraved legislators may favor legislative threats over formal legislation as a means to evade these constraints, such motivations, in and of themselves, are inconsequential to assessing the desirability (or undesirability) of threats on either functional or normative grounds.472

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467 Cf. Negotiated or Voluntary Agreements, supra note 415 (the regulator may monitor progress especially if a regulatory action follows a failure to comply).
468 See Richard Ford, Government to Public Revised Plans; Legal Reforms, THE TIMES, July 8, 1989 (“[W]ithout … continuing threat of legislation, the [legal] profession will have little impetus to take action to reform itself”).
469 See Winter, supra note 277, at A14.
470 Cf. Glaeser & Shleifer, supra note 85 (courts are prone to subversion).
471 See Laffont & Tirole, supra note 86 (explaining regulatory capture). For empirical evidence showing the distorting effects of regulatory capture on behavior and social welfare see Slinko et al., supra note 86.
472 Motivations may vary. Being aware that their power is sometimes limited by public opinion, legislators may issue a legislative threat in lieu of formal legislation in order to avoid negative public opinion. See Puzzanghera, supra note 166 (“legislation isn’t the only way federal officials can have an impact on an issue they are keenly aware may resonate with voters”).
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1. Disenfranchising Fellow Legislators: Non-majoritarian Policy-making

Legislative threats bypass the lawmaking process, thereby effectively disenfranchising legislators at the House and Senate. In doing so, the legislator evades floor discussion and potential input from competing perspectives; hinders committee hearings and deliberations; and sidesteps a plenary voting on the final passage of the bill in both houses of Congress—all of which comprise a standard legislative process.473 Indeed, legislative threats are inconsistent with the fundamental notion that the “Constitution provides a basic framework which provides for order and liberty [and] allows the majority of the people to make economic, social and political decisions about life in America which are binding on everyone.”474

Along the same lines, by using legislative threats, legislators avoid potential filibusters (or the threat thereof), ordinarily used to delay the debate on the proposed bill or block the legislation altogether. When successful, the filibuster tactic increases the bargaining power of legislators who oppose the legislation and seek to influence the contents of the legislation.475 A legislative threat that was issued in an attempt to ban gambling on collegiate athletics, demonstrates this point, in that the threat was issued after “[t]he resolution … was passed by the Judiciary Committee with an encouraging margin … was delayed by a Nevada filibuster in the Senate until the end of the term.”476

Moreover, even where legislators apparently adhere to the rules of the legislative process (e.g., introduce the proposed bill, hold a committee hearing), they do so strategically—that is, only to the extent that doing so enhances the credibility of the threat or increases the perceived probability of the threatened legislation. Senator McCain, who threatened legislation in an attempt to curb steroid use in baseball, is reported to have said that holding the high-profile hearings before the Senate Commerce Committee has been an attempt to coerce the baseball league to act.477

By using a legislative threat to opt-out of the political policy-making process and to avoid the majoritarian decisional rules (which are used to aggregate social preferences on a particular policy concern), the legislator acquires the power to induce policy changes notwithstanding the lack of congressional support.478 Thus, lawmakers increasingly become individualistic policy entrepreneurs. The exercise of this policy-

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473 See generally Legislative Process: How a Senate Bill Becomes a Law, supra note 328 (the legislative process).
475 Filibuster, the tactic of holding the Senate floor to debate a bill in an effort to delay or prevent an action on that bill, has long congressional history. See Filibuster and Cloture, U.S. Senate Powers & Procedures, at http://www.senate.gov/artandhistory/history/common/briefing/Filibuster_Cloture.htm (last visited Feb. 17, 2004). Legislative threats are particularly troubling where using cloture—namely, a two-thirds vote necessary according to Senate rules to end a floor debate and override a filibuster—is unlikely.
476 See Edwards, supra note 118. The threat led the Nevada Gaming Commission to recommend bet limits.
477 The hearings signaled the seriousness of the legislators’ intention to act. See Puzzanghera, supra note 166.
478 Notably, a threat may induce compliance even in the absence of a majority in support of the threatened legislation because the threat’s inducement effect depends on the firm’s belief that the following conditions are satisfied: (i) the threat is credible; and (ii) the probability that the threatened legislation is enacted into law is sufficiently high. In other words, where the legislation is sufficiently harmful, compliance with the legislator’s demands may become a rational choice even in the absence of the minimally-necessary congressional support.
making power is neither institutionally-regulated nor democratically-accountable. Consequently, these threats prevent fellow legislators from filling their democratic function to serve as bulwarks of deliberation and representation. And, as legislative threats are premised upon a non-majoritarian mechanism, their use becomes patently anti-democratic.\textsuperscript{479} Viewed from a social planning perspective, the prevalent use of threats to control social behavior runs afoul the fundamental principles of a political society that aspires to representative democracy, in which representatives in both houses of Congress are “constitutionally empowered to deliberate together and figure out statutory solutions to emerging problems.”\textsuperscript{480}

2. \textit{Disenfranchising the President: Preventing Possible Veto of Legislation}

Once a bill is approved by a majority vote in both the Senate and the House, it is presented to the President, who may sign the bill into law or exercise his veto power.\textsuperscript{481} If the President objects to the legislative measure, he may return it to the chamber of origin together with a veto message, stating his objections. Congress must then muster a two-thirds majority (in both houses) in order to override the President’s veto and enact the bill into law.\textsuperscript{482} In this respect, the capacity of legislative threats to bypass the political process and to promote a new public policy without resort to formal legislation clearly impedes the President’s constitutional veto power. This is particularly disconcerting nowadays, where frequent and resolute use of veto power has become an important vehicle used by the President’s to influence federal policy-making.\textsuperscript{483}

Using legislative threats to force a change in behavior disturbs the institutional allocation and separation of powers in one more way. Ordinarily, the power to make law (which is entrusted to legislators) does not encompass the power to enforce that law (which is entrusted to the government). In this respect, legislative threats bypass the Executive Branch and thereby usurp its discretionary law enforcement power, which would have otherwise rested with the Attorney General and other government officials. This unilateral, extra-legal assumption of power runs afoul fundamental separation of powers, thereby running the risk that law-makers become overly powerful.

3. \textit{Disenfranchising the States: Redrawing Federal-State Allocation of Powers}

Legislative threats can induce targeted entities to modify their behavior in

\textsuperscript{479} See Donald Wittman, \textit{The Myth of Democratic Failure: Why Political Institutions Are Efficient} 152-161 (1995) (discussing the role of majority rules in aggregating individuals’ preferences). By counting numbers, majority rules do not give weight to the intensities of individuals’ preferences, consistent with democratic principles.

\textsuperscript{480} See Bruce Ackerman, \textit{We the People: Foundations} 260 (1991).

\textsuperscript{481} See U.S. \textsc{Const.}, art. I, § 7. If the subject matter of the bill is within the jurisdiction of a department of the government or affects its interests in any way, the President may in the time allotted refer the bill to the head of that department for opinion and report thereon. See \textit{Enactment of a Law}, U.S. \textsc{Senate}, at \url{http://www.senate.gov/legislative/common/briefing/Enactment_law.htm} (last visited Feb. 17, 2004).

\textsuperscript{482} See Farnsworth, supra note 2, at 66. If the President does not sign the bill or exercise his veto power outright (i.e., within ten days), the bill becomes law automatically. See also Redman, supra note 112, at 235-36.

\textsuperscript{483} Cf. Ackerman, supra note 480, at 260-61 (“[T]he President’s aggressive use of his veto power in the modern republic is radically different from its use in the early republic”).

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accordance with the legislator’s demands. Yet, the targeted conduct may be one that lies beyond Congress’ Article I powers and that therefore is exclusively subject to states’ sovereign regulatory power. Hence, the policy-making power that arises from the use of threats can disturb principles of federalism, in that it redefines federal-state allocation of regulatory responsibilities in violation of the Tenth Amendment. Because the use of legislative threats is entirely unregulated and most often not as visible as ordinary legislative business is, federal legislators may use the power these threats confer to control behavior and induce a policy change in areas exclusively reserved for the states, thereby usurping state sovereign interests. And, that threat-induced policy changes evade judicial review (as I explain below) further reinforces this problem.

Similarly violating state sovereignty, national legislators may employ legislative threats to comandeer state legislatures and state executive officials. Specifically, legislators may direct a federal legislative threat to state lawmakers, according to which they will legislate unless state lawmakers regulate the targeted conduct themselves. Along the same lines, legislators may threaten adverse legislation unless state officials and administrative agencies comply with the legislator’s demands (e.g., that they enforce a particular federal law). The comandeering effects of legislative threats clearly intrude upon the state sovereignty, which the Supreme Court has invoked in a number of cases to hold that Congress could neither comandeer state lawmaking processes by forcing states to regulate, whatever the substantive field might be, nor can “[t]he Federal Government … issue directives requiring the States to address particular problems [or] command the States’ officers, or those of their political subdivisions, to administer or enforce a federal regulatory program.”

4. Disenfranchising the Constitution: Evading Judicial Review of Legislation

Judicial review of statutes imposes an important external constraint on the scope of legislative power, necessary to prevent political majorities from abusing their legislative power so as to oppress political minorities. Yet, effective legislative threats, which produce no formal legislation but give rise to informal norms of conduct, are not subject to this institutional constraint. Specifically, threat-induced policy changes (whether they are achieved through self-regulation or regulatory bargaining) practically foreclose potential judicial review. The resulting standards of conduct compromise the protection of constitutional rights and adherence to constitutional principles. In other words, legislative threats give rise to a body of invisible law to which fundamental constitutional principles practically cannot apply. In the process, the targeted entities

484 “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” U.S. CONST., amend. X. See Tribe, supra note 45, at 860.
485 While the reverse scenario, where state legislators direct a state legislative toward Congress, is a theoretic possibility it is practically not a viable option.
488 See Tribe, supra note 45, at 207-213 (discussing the role of the judiciary in interpreting and applying the Constitution to determine constitutional validity of legislation).
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are forced to conduct themselves and their business according to standards that do not necessarily meet requisite constitutional protection of rights and liberties.\textsuperscript{489} In this respect, the use of legislative threats to control social conduct creates a constitutional duality, wherein formal norms are subject to external constitutional constraints while informal ones are not. To be sure, such a duality is blatantly inconsistent with the key societal role of the Constitution, which “[f]or the past two centuries, ... has been as central to American political culture as the New Testament was to medieval Europe.”\textsuperscript{490}

Even worse, this problem reaches far beyond constitutional protection \textit{per se}. In effect, limiting the operative reach of the Constitution and excluding a body of “norms” from constitutional jurisprudential discourse work to the detriment of the long-term functioning of the courts and adversely affect the function the Constitution serves in regulating the use of legislative power. The point here is the following: the depth, extent, and sophistication of constitutional jurisprudence and doctrine depend (among other things) on the aggregate legal experience of courts and on the case-law they develop. Hence, as more constitutional cases are brought before the courts on the grounds that a norm is unconstitutional, the more well-developed will constitutional jurisprudence and doctrine become; ands vice versa. In other words, constitutional challenges benefit from network effects, wherein the quality and depth of the applicable doctrine increase with the frequency and volume of judicial review.\textsuperscript{491} Fewer norms and fewer challenges necessarily mean that pertinent constitutional doctrine is bound to remain less developed—and, therefore, more uncertain—than it would otherwise have been. Moreover, the erosion of constitutional doctrine, which increases legal uncertainty, may further reduce the frequency of constitutional challenges and the volume of cases brought. Furthermore, the use of legislative threats and the resultant constitutional duality not only expose threat-recipients to possibly-unconstitutional standards of conduct but also degrade constitutional protection afforded to others (whose conduct is subject to legitimate legal norms). Taken together, these trends are likely to counter the trend towards juristocracy, wherein by virtue of constitutional rights and judicial review of legislation and regulation, courts become an important regulatory institution and play an ever more powerful role in policy-making.\textsuperscript{492}

Counter-intuitively, the \textit{ex ante} prospect that (if and when enacted) the threatened legislation may be held unconstitutional and void does not automatically water down the threat’s inducement effect on behavior. Such constitutional challenge may bear on the probability that the threatened legislation remains legally-effective notwithstanding

\textsuperscript{489} See, e.g., Sheinin, supra note 403, at 101 (suspicionless drug testing requirements with which threat recipients comply violate the Fourth Amendment protection against searches without probable cause).


\textsuperscript{491} Network effects arise when a product’s value to a user increases as the number of users of a product grows. The fundamental idea is that the act of joining a network confers a benefit (externality) on all other participants in the netwrok. See William H. Page & John E. Lopatka, \textit{Network Externalities}, in Boudewijn Bouckaert & Gerrit De Geest (eds.), \textit{ENCYCLOPEDIA OF LAW AND ECONOMICS}, Vol. II. 952 (2000).

\textsuperscript{492} See Ran Hirschi, \textit{Towards Juristocracy: The Origins and Consequences of the New Constitutionalism} 169-172 (2004) (discusses the trend towards judicial empowerment through the constitutionalism of rights and the establishment of procedures for judicial review).
constitutional challenges (or, rather, held unconstitutional and void). In other words, constitutional challenges are merely one factor among many that influences the firm’s assessment of the efficacy of the threat (i.e., whether or not the probability that the threatened legislation becomes a law exceeds the effectiveness condition). If the threatened legislation entails sufficiently harmful impact, compliance with the legislator’s demands may qualify as the firm’s best response despite a possibly-meritorious constitutional challenge. In any event, the strength of these challenges and their bearing on the effectiveness of the threat depend on a variety of factors, including the court’s composition and the constitutional jurisprudence on the issue under review.

Precisely this counter-intuitive effect seems to explain the repeated resort to legislative threats as a means to control freedom of speech in America. Over the years, lawmakers have had a significant impact on self-censorship, profanity, and other forms of otherwise-protected speech. Using legislative threats, legislators exerted pressure to shape the content of films, comic books, and popular music and TV broadcasts notwithstanding Congress’ highly limited mandate to regulate speech under First Amendment jurisprudence. In one case, President Clinton’s administration directed a threat of federal legislation towards the entertainment industry in an effort to stop the marketing of violent movies to kids, reasoning that the measure was intended to “encourage the industry ... to do some self-regulation.” Illustrating the appeal of legislative threats as a means to force constitutionally-invalid policy changes, Dick Cheney is reported to have said “[t]hey know that you cannot enact legislation or regulation to take care of this matter without running afoul of the First Amendment.”

In line with this response, Hillary Rosen, the President of the Recording Industry Association of America stated in a testimony before the House Subcommittee on Telecommunications and the Internet that the legislation would force the creative industries to adhere to certain standards based on value judgments made by the government about content and that “this legislation [is] blatantly unconstitutional.”

5. Disenfranchising the Judiciary: Circumventing Judicial Interpretation

The use of potential constitutional threats to control social behavior disturbs the institutional
allocation of responsibilities and the political separation of powers in one more way. Because effective legislative threats are not carried out and produce no formal legislation (nor a legally-enforceable agreement\textsuperscript{499}), the forced changes in the conduct of entities towards which the threat is directed fall beyond the reach of the legal system and out of the purview of courts. In fact, given the absence of formal legislation, policy changes forced by legislative threats—far-reaching as they may be—cannot give rise to recognized legal actions. Thus, viewed from an institutional perspective, legislative threats disenfranchise the judiciary, which is ordinarily entrusted with the responsibility to adjudicate legal controversies. And, absent adjudication of legal controversies, courts cannot do what they do best—namely, laying precedent-setting interpretations and “shaping the rules of law [and] heed[ing] the \textit{mores} of [the] day.”\textsuperscript{500}

\section*{V. Normative Analysis: Assessing the Desirability of Legislative Threats as Regulators of Social Conduct}

Threat-induced behavior is all but omnipresent. Deterrence of wrongdoing, for instance, is predicated upon a threat of \textit{ex post} liability for the harm caused. Similarly, out-of-court settlement is often observed in response to a party’s threat to litigate the case.\textsuperscript{501} And, in 2002, Bayer A.G. lowered the price of Cipro, at the time a highly demanded antibiotic, following the federal government’s threat to revoke its patent and manufacture the drug itself.\textsuperscript{502} Having said that, nowhere are the effects of threat-induced behavior as controversial and socially-costly as those associated with legislative threats.\textsuperscript{503} Specifically, the preceding analysis has established that, notwithstanding the superior functional capacity of legislative threats to control behavior in an increasingly-complex and information-intensive society, the institutionally-unregulated and politically-unaccountable use of implicit and explicit threats poses formidable normative challenges for the most treasured attributes of American constitutional democracy. Contrasting these considerations underscores the intrinsic, possibly-irreconcilable tension between the potential welfare gains and the toll on democratic principles arising from the prevalent use of legislative threats as a means of social control. This conflict therefore raises the ultimate normative question, namely—\textit{Is the use of legislative threats as regulators of social conduct socially desirable?}

The analysis that follows aims to address this question against two well-defined normative criteria—(i) democratic legitimacy and (ii) social control efficacy—and to carefully examine how the use of legislative threats measures up against these criteria.

\begin{itemize}
  \item Arguably, agreements that the parties enter into in the shadow of the threat are not enforceable because, among other things, they are consummated without authority and provide no legally-effective consideration.\textsuperscript{499}
  \item See Benjamin N. Cardozo, \textit{The Nature of the Judicial Process} 103-104 (1921) (emphasis in original).\textsuperscript{500}
  \item See, e.g., I.P.L. P'ng, \textit{Strategic Behavior in Suit, Settlement, and Trial}, 14 BELL J. ECON. 539 (1983).\textsuperscript{501}
  \item See Clyde Haberman, \textit{New Urgency on Anthrax, Bombs and Blunders, the Ripple Effect}, N.Y. TIMES, Oct. 24, 2001, at B1.\textsuperscript{502}
  \item Regulation through litigation has been subject to criticism on the grounds that devising regulatory policies in settlement of large-scale litigation disenfranchises constituencies and is therefore anti-democratic. As I show below, the anti-democratic effects of legislative threats pose even graver concerns.\textsuperscript{503}
\end{itemize}
In order to maximize social welfare, the deployment of any regulatory mechanism to control social conduct must satisfy two conditions: (i) it must minimize the intrusion upon democratic legitimacy; and (ii) it must maximize regulatory efficacy. In other words, the social benefits from social control must exceed the social cost of using the particular mechanism to promote social interests.

Against these criteria, the normative analysis outlines the best domain of legislative threats: that is, a set of conditions and circumstances where the use of legislative threats is socially-desirable. In keeping, the discussion offers an alternative mechanism that, while responsive to pressing challenges of social control, is also designed to optimize the inevitable trade-off between democratic legitimacy and social control efficacy.

A. The Effects of Legislative Threats on Social Control Efficacy

The regulatory efficacy of legislative threats cannot be underestimated. The case studies examined in Part II and the discussion presented in Part IV have demonstrated that threat-induced self-regulation and threat-induced co-regulation (i.e., regulatory bargaining in the shadow of a legislative threats) are functionally-superior to formal means of social control. Without rehashing the earlier discussion, these comparative advantages arise from the instrumental capacity of legislative threats to flexibly and effectively secure vital social interests in circumstances where formal legislation and regulation are invariably destined to founder. Hence, legislative threats can be viewed as an inevitable response to the systemic limitations of lawmakers and the inherent limits of the law.

Indisputably, the efficacy of legislative threats improves upon society’s ability to control social behavior, increases individual well-being, and enhances social welfare, thereby making everyone better-off. The corresponding reduction in the social cost of lawmaking and the significant cost of law enforcement further increases social welfare.

B. The Effects of Legislative Threats on Democratic Legitimacy

Threats to use legislative power to enact unfavorable legislation enable legislators to force entities—without any resort to law enforcement and adjudication—to comply with non-majoritarian, possibly-unconstitutional standards of conduct. The use of legislative threats therefore runs afoul fundamental democratic tenets, including in particular those upon which the American constitutional democracy is premised. The hefty toll on the foundations of democracy derives from various effects of legislative threats on procedural safeguards, institutional constraints, and substantive controls designed to limit legislative power, heighten the quality of policy-making processes, and ensure that constitutionally-protected rights and principles are not violated.

Several effects, which I have identified in Part IV, are particularly noteworthy. First, legislative threats induce compliance with non-majoritarian standards of conduct that neither reflect the preferences of electoral constituencies, nor incorporate competing views. Second, legislative threats impede the President’s veto power and

504 Commentators maintain that regulators are unquestionably better-positioned than judges to devise
weaken the White House’s capacity to influence federal policy-making. Third, legislative threats obviate disputes that might have arisen if the threatened legislation were enacted, thus precluding adjudication, statutory interpretation, and doctrinal development. Fourth, legislative threats undermine the judiciary’s ability to ensure that legislative power is used in accordance with constitutional limits. Fifth, legislative threats disrupt the fine-tuned allocation of powers between the national and state levels of government, thereby facilitating excessive federal intrusion in state sovereign affairs.

Taken as a whole, these effects empower legislators who, by virtue of threats, are able to usurp the functions and responsibilities that ordinarily rest with other branches of government. In other words, by employing legislative threats, legislators encroach upon the constitutionally-defined territories of Congress, the President, and the judiciary. Such excessive legislative power is clearly at odds with the most fundamental principles at work in a system that adheres to separation of powers, where the use of power is subject to reciprocal checks and balances. Moreover, augmented legislative power is further irreconcilable with the basic precept that popularly responsive institutions, not a singular representative, should be in charge of making substantive value choices. For these reasons, such power remains unwarranted notwithstanding that, (i) the separation of powers and the tendency for Republicans and Democrats to control different branches of government help produce occasional policy stalemate; and (ii) that persistent partisan differences may result in awkward policy compromises and flawed regulatory programs. Therefore, even though legislative threats enhance the society’s capability to control increasingly-complex conduct and increase social welfare, the legitimacy problem is inevitable. This becomes ever more palpable in light of Earl Warren’s unambiguous admonition that “[t]he foundation of our society is the Constitution. It establishes our institutions, defines their procedures, limits the power of government, guarantees our rights as citizens, and imposes responsibilities on all of us commensurate with them.”

Predictably, infringements on democratic ideals and violations of constitutional principles are viewed unfavorably and therefore decrease social welfare. Specifically,
such intrusion is perceived as a threat to the society’s democratic credo,\textsuperscript{510} according to which legal rules allocate decision-making power among government branches.\textsuperscript{511} Attesting to its importance, “Americans use the rule-of-law idea as a tuning fork to test not only the performance of their officials but also the quality of their society.”\textsuperscript{512}

Lastly, the democratically-unaccountable and institutionally-unregulated power that arises from the use of legislative threats distorts private incentives to invest and innovate, and undermines sustained economic growth.\textsuperscript{513} Specifically, as power increases and institutional checks and balances weaken, the societal framework within which all economic activities take place commensurately becomes less stable. Rising instability intensifies the risk of economic harm and wealth appropriation to which one is exposed, alas without a compensatory increase in the rate of return on investment (which is necessary to offset the effects of increased instability). Under these conditions, private investment incentives stifle. In other words, break-down in the orderly rule of law framework, which is necessary to facilitate private investment, is inevitably followed by a decline in economic growth and diminishing social welfare. Along these lines, history shows that when given a choice between a state (however exploitative it might be) and anarchy, individuals have decided for the former, for any set of rules is better than none.\textsuperscript{514}

C. Normative Assessment and Reform Proposals

How, then, does the pervasive use of legislative threats measure up against the social interest in maximizing regulatory efficacy and minimizing intrusion upon democratic principles and institutional legitimacy? On balance, it seems that even though the benefits of legislative threats may exceed their short-term cost (thus becoming efficient in the short-term), in the long-term the reverse is true, thus suggesting that the best domain of legislative threats consists, in fact, of an empty set.\textsuperscript{515} Stated differently, any increase in individual well-being and aggregate social welfare—due to the improved efficacy of social control—is inevitably outweighed by a higher commensurate decrease in well-being and social welfare, reflecting in turn the toll of violating constitutional and democratic principles; the negative impact on societal stability and the disincentive on private investment; and the consequential decline in economic growth.

\hspace{1cm} various interests that individuals care about (e.g., liberty, protection of property, legal certainty, fairness). Second, a Rawlsian “veil of ignorance” reasoning reinforces individuals’ preference for the democratic \textit{status quo} over alternative and uncertain states of the world.

\textsuperscript{510} See Warren, supra note 474, at 167 (“[W]here there is no law there can be no freedom, particularly for the less advantaged members of society. When law breaks down anarchy prevails”).

\textsuperscript{511} See Schauer, supra note 506, at 159 (“[R]ules are essentially jurisdictional [as they operate] as devices for determining who should be considering what”).

\textsuperscript{512} See Mary A. Glendon, \textit{A Nation under Lawyers} 11 (1994).

\textsuperscript{513} \textit{Cf.} North, supra note 453, at 21-24 (the state’s essential role in sustaining stability and growth over time).

\textsuperscript{514} \textit{Id.}, at 24.

More specifically, the long-term social cost of legislative threats comprises: (i) higher risk of economic harm and appropriation of individual wealth (including, but not limited to, any gains realized from improved control of social behavior); (ii) the higher societal instability, lower investment incentives, and reduced economic growth; and (iii) the intrinsic decrease in well-being due to violating individuals’ intrinsic preference for maintaining the constitutional democratic form of government. Therefore, viewed from a social welfare perspective, the use of explicit or implicit legislative threats as a means to control social conduct is unambiguously objectionable and should therefore be outright prohibited.516

Improving society’s ability to control increasingly-complex and information-intensive social activities promises greater regulatory efficiency, lowers compliance costs, and increases social welfare.517 Hence, the pursuit of effective and normatively-acceptable means of social control (i.e., that maximize regulatory efficacy while minimizing the toll on democratic legitimacy) warrants consideration. This, because failure to effectively manage the rapidly-changing and ever more challenging demands of social control has negative repercussions on economic growth, individual well-being, and social welfare. The intellectual and practical task should therefore focus on conceiving social control measures and designing mechanisms that reproduce (albeit, to the extent possible) the inducement effect of legislative threats. More specifically, that mechanism should replicate the functional capacity of threats to induce firms to adopt cost-effective standards of conduct, through either self-regulation or co-regulation, without compromising democratic processes or violating constitutional principles. Along these very same lines, Earl Warren has imparted that the problems of social control “can be remedied and the [regulatory] structure completed in keeping with the original design … through a rededication to that design which recognize[s] that the essential ingredient of our system is the co-existence of order and liberty.”518

The solution, I argue, is found in the province of legislation (rather than the threat of legislation). The nature of the legislation, however, must “change to keep pace with changes in the economy and society.”519 Specifically, the following generic schema—

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516 Anticipatory threats do not implicate similar concerns and therefore pose no problem from a normative perspective. If any, anticipatory threats that lead firms to modify their behavior are socially-desirable because they improve social control and reduce lawmaking and enforcement costs, but involve no undesirable impact.

517 Project XL represents a new approach to improving social control in an attempt to further environmental and public health objectives. Coordinated by the EPA’s Office of Policy, Economics, and Innovation, the project is a national pilot program that allows state, local governments, businesses, and organizations to develop with EPA innovative strategies to test better or more cost-effective ways of achieving environmental and public health protection. In exchange, the EPA allows the regulatory flexibility during the duration of the experiment. See Project XL, ENVIRONMENTAL PROTECTION AGENCY, at http://www.epa.gov/ProjectXL (last visited Feb. 17, 2006). Viewed from a social welfare perspective, this approach is inferior to the one I presently develop. See Thomas P. Lyon, Voluntary versus Mandatory Approaches to Climate Change Mitigation, RESOURCES FOR THE FUTURE ISSUE BRIEF 03-01 (2003), available at http://www.rff.org/Documents/RFF-IB-03-01.pdf (voluntary programs cannot achieve the same level of environmental protection as mandatory programs).

518 See Warren, supra note 474, at 71.

outcome-oriented or risk focused, deferred-implementation, contingent sunset legislation—is capable of providing the desired panacea. According to this proposal, legislators enact into law a legislative measure that specifies policy objectives (i.e., a “purpose clause,” an “enactment clause”), which targeted entities aim to attain.\textsuperscript{520} Depending on the features of the targeted conduct, the legislation may establish outcome-oriented targets (e.g., reduction of gas emissions, eradication of steroid use by athletes) or risk-focused targets (e.g., low risk of money laundering, low risk of e-piracy).\textsuperscript{521} The legislation also: (i) lay out implementation procedures, including the adoption of voluntary codes of conduct, submission of self-regulation proposals for approval by a designated agency, or holding regulatory bargaining; and (ii) set out compliance deadlines, that is, the time allotted for submitting a voluntary code or for consummating bargaining. Thus, whereas policy objectives, implementation procedures, and timetables are fixed in law, businesses are given broad discretion to decide how it is best to meet these goals.\textsuperscript{522}

Most importantly, in order to ensure sufficient incentives and induce entities to devise and adopt the most practicable measures capable of achieving the stated policy objectives, the legislation must contain a default command-and-control regulatory scheme, the legally-binding effect of which is governed by a front-end deferral clause and a back-end sunset clause.\textsuperscript{523} On the front end, the deferral clause postpones the scheme’s effectiveness until a predetermined future date, thus providing entities with sufficient time to devise necessary measures and to change their conduct in line with the statutory targets. On the back end, the sunset clause provides that when the deferral period comes to an end, the command-and-control scheme will automatically expire.

\textsuperscript{520} It is certainly not uncommon for federal legislation to be introduced by a preamble or a purpose clause which may identify the problem which the act seeks to remedy or set out the object and purpose of the legislation. The recently-enacted Class Action Fairness Act of 2005 provides an excellent example. Section 2, titled “Findings and Purposes,” states that “The purposes of this Act are to assure fair and prompt recoveries for class members with legitimate claims [and] benefit society by encouraging innovation and lowering consume prices.” See Class Action Fairness Act of 2005, PUB. L. NO. 109-2, 5, 119 STAT. 4 (2005). Ordinarily, a primary source of legislative intention is found in the purpose clause itself.

\textsuperscript{521} Environmental protection officials in the U.K. are putting to the test the use of outcome-focused and risk-based regulatory methods. See Delivering for the Environment: A 21st Century Approach to Regulation, supra note 519. In keeping with this Article’s normative prescriptions, the British approach is functionally flawed because it provides no inducement mechanism that is necessary to guarantee the success of such approach.

\textsuperscript{522} In an attempt to achieve environmental goals without recourse to legislation, the European Commission has proposed rules in which policy objectives and timetables are fixed in law but the decision how to meet them is given to businesses. These rules are hoped to encourage voluntary agreements with industry sectors. See EU-rules for Voluntary Agreements, at http://www.eceee.org/latest_news/2002/news20020717.lasso (last visited May 1, 2004). As with the U.K. experience, the key problem with these rules, however, is that (absent legislative threats) they lack any inducement mechanism. My proposal addresses precisely this problem.

\textsuperscript{523} This element of my proposal—which produces a credible threat—is the key to obtaining regulatory efficacy. Its absence from several regulatory approaches that have been developed in recent years seems to explain their failure or sub-optimal results. See, e.g., Cary Coglianese & David Lazer, Management-Based Regulation: Prescribing Private Management to Achieve Public Goals, 37 LAW & SOC’Y REV. 691 (2003) (discussing “management-based regulation,” which directs regulated organizations to engage in a planning process that aims toward the achievement of public goals).
(i.e., permanent sunset) or be suspended (i.e., temporary sunset),\textsuperscript{524} unless entities fail to change their conduct and adequately meet predetermined targets. This determination should be made by a designated agency, according to statutorily-defined and observable criteria.\textsuperscript{525} While it might be difficult or even impossible to observe internal practices and compliance measures, it is often possible to monitor certain performance indicators through inspection, testing, or auditing.\textsuperscript{526} Furthermore, when monitoring is not economically- or technologically-feasible, an anti-sunset clause—providing a presumption against sunset whenever compliance is indeterminate—will shift the burden of verification, thereby ensuring that the firm voluntarily divulges sufficient information showing it has adopted measures necessary to achieve the stated objectives.

In distinct contrast to legislative threats, this proposal relies upon formal legislation as a means to induce firms to adopt cost-effective measures necessary to achieve predetermined policy objectives. The mechanism harnesses the functional advantages of threat-induced self-regulation and of threat-induced co-regulation, wherein firms adopt the most practicable measures in order to secure social goals.\textsuperscript{527} The latter becomes possible because the legislation (rather than the threat thereof) imposes a credible threat on targeted firms, according to which their failure to take proper measures will activate the command-and-control scheme.\textsuperscript{528} Given firms’ superior capacity to self-regulate, any default command-and-control scheme is bound to decrease their profits and make them worse-off.\textsuperscript{529} As a result, the threat induces firms to devise voluntary codes and measures or engage in regulatory bargaining—which are both better-suited than adversarial legislation to deal with the complexity of social activities—so as to avert the unfavorable impact of command-and-control requirements.\textsuperscript{530} Moreover, the threat may also reinforce firms’ tendency towards

\textsuperscript{524} Assuming all else remains equal, temporary sunset is preferable to permanent sunset because once the legislation expires, the incentives to continue incurring the expenses of costly compliance significantly weaken unless the legislation is re-enacted. Temporary sunset is further desirable because it ensures that targeted entities continuously evaluate and modify their conduct in order to secure that the stated policy objectives are achieved even though circumstances change. Cf. A Framework for Evaluating Voluntary Codes, CANADA OFFICE OF CONSUMER AFFAIRS 10 (1998), available at http://strategis.ic.gc.ca/volcodes (last visited Jan. 5, 2004).

\textsuperscript{525} Designating a monitoring agency is not uncommon. The SEC, for example, reviews the intended purpose and statutory basis of rules proposed by the NYSE. Similarly, the U.K. Treasury was appointed in one case to review financial institutions’ money-laundering monitoring programs. See Legislation Threat to Banks’ Self-Regulation, supra note 152.

\textsuperscript{526} See, e.g., Monitoring Proforma for Commercial Leases Code of Practice, supra note 165 (monitors appointed).

\textsuperscript{527} Similarly to legislative threats, this approach to social control enables “industry partners to identify the reduction opportunities that best suit their local operations and that provide maximum protection for the environment.” See Lucent Technologies Signs Voluntary Agreement with EPA, supra note 159.

\textsuperscript{528} The idea of automatic fulfillment serves as a commitment mechanism that guarantees the credibility of the threat (and the credibility of the inverse implicit promise). The logic is that when carrying out a threat is determined \textit{ex post} by an independent, self-executing mechanism, the threat becomes \textit{ex ante} credible. See Dixit & Skeath, supra note 219, at 308.

\textsuperscript{529} The superiority of self-regulation is discussed and substantiated in Part III(A)(3)(d) above.

\textsuperscript{530} Adopting voluntary codes may confer additional benefits on targeted firms, as they can point to these codes as a form of responsible social conduct and enhance their “good corporate citizen” image. See Voluntary Codes versus Legislation, in TOBACCO IN AUSTRALIA: FACTS AND ISSUES § 15.3 (1995), available at
organization, so as to reduce the transaction costs of regulatory bargaining and to increase the likelihood of industry-wide compliance. Lastly, the threat may induce firms to cooperate with related interest groups and integrate their perspectives into the process, thus giving them power to influence the ultimate rules of conduct. 531

Counter-intuitively, formal legislation may be functionally superior to legislative threats: while the probabilistic nature of legislative threats may in certain circumstances render credible threats ineffective (i.e., when the probability that the threatened legislation will be enacted into law falls below the effectiveness condition), the current proposal surmounts this problem. Specifically, enacting the command-and-control scheme into law virtually eliminates the probabilistic feature of the threat to enact adverse legislation. Then again, that a formal legislation can (at least in theory) be repealed at any point of time inevitably weakens its inducement effect. Complete compliance with the stated policies therefore cannot be guaranteed. Lastly, in contrast to non-majoritarian legislative threats, formal legislation is generally the result of political compromises. Hence, compared with legislative threats, formal legislation is likely to impose more lenient targets and is therefore unlikely to realize maximum gains from social control.

**CONCLUSION: THE LIMITS OF LAW AND THE EMERGENCE OF THE SECOND-ORDER REGULATORY STATE**

Economic growth has many virtues. First and foremost, it increases society’s wealth and, when wealth is justly distributed in society, it also improves the quality of life and the standard of living of its members. Growth also entails a rising demand for products and services, which stimulates employment and encourages capital investment. In turn, growth has a positive effect on firms’ profits: this increases returns on equity and lowers the cost of capital, thereby sustaining a continued expansion of the economy. Lastly, growth offers the government a fiscal dividend from increased tax revenues.

The immense benefits notwithstanding, economic growth and social progress are not free of problems. Specifically, these processes inevitably increase the speed of societal change: advances in technology, the wealth of information, the increase in population, and the constant migration of people and work across borders are but a few of the far-reaching transformations. Indeed, Nobel laureate economist Douglas North has forewarned that “the process of growth is inherently destabilizing to a state.” 532 In this respect, the exponential increase in the complexity of activities and the rapid changes in behavior across all social domains are two major sources of growth-driven instability. Paradoxically, absent effective social control, the processes that drive well-developed market economies towards economic growth, technological advancement, and cultural progress, may ultimately propel their inevitable economic decline, increase

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531 See David Vogel, *Kindred Strangers* 73, 74 (1996) (discusses the advantages of cooperative regulation in the U.K. and its impact on environmental public policy, and noting that “the British have been more successful in integrating environmental pressure groups” into the regulatory process).

532 See North, supra note 453, at 29.
social instability, and lead to their gradual societal deterioration. Therefore, the more advanced a society becomes the more demanding is the lawmakers’ role: maintaining order and eradicating disorder—that is, the sin quo non of continued economic growth—require exacting social control measures, flexible legal intervention, regulatory acumen and finesse and, above all, considerable amount of information.

These observations suggest that lawmakers face an overwhelmingly difficult task, the results of which are consequential to social welfare. In particular, limited data or, alas, an unstructured wealth of information; the inability to accurately assess risks and project possible outcomes; insufficient knowledge of relevant processes, relationships, and methods; and, above all, lack of time and resources—compound the legislators’ responsibility and render sound policy-making all the more challenging. Documenting the rising challenges to effective control of social conduct, commentators note that as social reality becomes ever more complex, legal rules become so too. Furthermore, the trend towards legal complexity affects the government, which “grows in complexity just as our society does.” In view of these problems, the law’s tormented regulatory efficacy and the counter-productiveness of state intervention should surprise none.

In light of the foregoing, it is fair to say that the “[l]aw confronts unprecedented challenges today as it seeks to order an astonishingly dynamic American society.” Moreover, the limits of law and lawmakers are bound to intensify as the activities and conditions that the law aims to control become unruly. And, as these problems worsen, it is not implausible that the “law’s legitimacy will erode if and when a widespread belief takes hold that law has become incompetent in discharging [its] fundamental function.” While this concern is generally valid, it is particularly alarming for Americans whose diverse aspects of social life and economic activity inextricably depend on a well-functioning legal system.

Viewed as a whole, these trends underscore the growing incapacity of the legal system to deliver its pre-eminent promise: to maintain ordered liberty and to promote sound public policies. The specific role of the law, as a system of social governance,

534 See Epstein, Simple Rules, supra note 391, at 21-36 (documenting a massive increase over the past decades in the complexity of rules that govern society).
535 See Warren, supra note 474, at 67.
537 Id. at ix (emphasis in original).
538 Indeed, “the range of matters that can be litigated in the United States is broader than in other nations … there are few ‘litigation-free’ zones in twenty-first-century American life, domains in which no lawsuit can be brought. … [T]he United States relies more than any other nation on lawyers, rights, and courts to address social issues.” See Thomas F. Burke, Lawyers, Lawsuits, and Legal Rights: The Battle Over Litigation in American Society 3-4 (2002). See also Richard A. Posner, The Federal Courts: Challenge and Reform 87-92 (1996) (discussing and explaining the growth in federal courts caseload since 1960).
must therefore be re-examined and, possibly, re-conceptualized, notwithstanding the durability and robustness of social institutions to environmental change. For indeed, the “compatibility of order and liberty must be relearned and re-earned.” For, a society that fails to take account of these challenges and that disregards the ensuing pathologies runs the risk of heightened instability, economic stagflation, and social degeneration. Demonstrating the latter point, it has been suggested that due to failures of its legal system, the U.S. “was not able to create lasting institutions to match the new structures and strategies of private firms or to find appropriate social measures to offset the more destructive aspects of capitalist development.”

Legislative threats can be regarded as a spontaneous (in the sense of unplanned and unregulated) response to the functional limits of the law and the systemic failures of lawmakers, intended to reduce information and transaction costs associated with policy-making and regulatory bargaining. As such, legislative threats represent an attempt—albeit illegitimate and socially-unwarranted—to counteract the very social processes that undermine society’s ability to adequately control increasingly-complex and information-intensive activities. When using legislative threats, legislators impose background threats in order to induce entities to change their conduct and secure predetermined social interests. While legislators do not dictate the ultimate (first-order) rules of conduct, they lay down background (second-order) rules, pursuant to which industry-wide and market-driven arrangements are devised.

Viewed from an even broader perspective, the widespread use of legislative threats (which has been substantiated by examining ten diverse case studies in Part II) evinces an increasing tendency towards (what I label) a second-order social control system. Succinctly, this approach provides that, rather than decide the ultimate standards of conduct, legislators establish second-order rules designed to create the incentives necessary to induce entities and groups to adopt socially-desired rules of conduct. In its deepest sense, the second-order approach to control of social behavior highlights the pluralistic property of—what game-theorists John von Neumann and Oskar Morgenstern termed—the established order of society, where a comprehensive rigid system ultimately gives way to efficient particular governance arrangements which derive from general principles but nevertheless differ in particular respects. Inevitably, the trend toward second-order social control diminishes the traditionally-extensive role of the regulatory state; concomitantly, this trend increases the power of

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540 See Masahiko Aoki, Toward a Comparative Institutional Analysis 233-35 (2001) (explaining why specific institutional designs and governance systems may withstand significant background changes).

541 See Warren, supra note 474, at 71 (emphasis added).


543 Instead of creating first-order rules of conduct, lawmakers should establish second-order rules and second-order incentives, which are necessary to induce entities to self-regulate or co-regulate.

groups that, in shaping their regulatory environment, practically turn into islands of self-regulation. Under this approach, the state’s social governance role is practically relegated to setting policy objectives, while entrusting the design and adoption of specific measures to the regulated entities.

The decoupling of policy objectives from policy measures highlights the inevitable transformation of the post-New Deal regulatory state into a modern second-order regulatory state. Furthermore, because the second-order approach is predicated upon regulated entities’ self-regulation or co-regulation (which may require, in turn, long-term investment), the problem of commitment inescapably emerges. Specifically, unless the state can credibly commit itself to adhere to a consistent policy objectives through second-order social control measures, the regulated entities will have neither sufficient incentive to achieve the policy objectives, nor will they change their conduct or making any necessary investment. In other words, the state’s task is to design second-order social control and accompany these measures with a credible commitment to ensuring compliance with the stated policy objectives. Counter-intuitively, viewed this way the legal system exists not to prescribe the ultimate legal rules and standards but, rather, to facilitate conditions that are necessary to induce entities to regulate themselves. Lastly, the second-order approach to social control also turns the focus away from the dichotomous debate on the scope of state regulation (i.e., “nanny state” vs. “Pontius Pilate state”), and towards the commitment mechanisms used by the state to promote social policy interests.

Second-order social control comes in different forms, few of which are presently noteworthy. First, legislators may pass legislation along the lines I have proposed in Part V. As I have explained earlier, an outcome-oriented or risk-focused, deferred-implementation, contingent sunset legislation will induce the regulated entity to devise rules and measures that are necessary to achieve the statutory targets, so as to avert the negative impact of the legislation’s default command-and-control scheme. In this respect, the legal system facilitates the making of a credible threat.

Second, legislators may pass a legislation that requires entities that transact goods and services in the market to disclose pertinent information. The disclosure of such

545 Cf. Patrick Birkinshaw et al., Government by Moonlight: The Hybrid Parts of the State (1990) (noting that the state has transferred various public responsibilities to a spectrum of semiautonomous institutions).

546 This argument is consistent with casual observations in other social domains, showing an increased in the scope and frequency of private-public partnerships. See, e.g., Harold Demsetz, The Private Production of Public Goods, 13 J. L. & ECON. 295 (1970).

547 Credibility is vital to the regulatory success of second-order social control. Lack of credibility undermines the state’s ability to induce entities to change their conduct and make necessary investment. See Amihai Glazer & Lawrence S. Rothenberg, Why Government Succeeds and Why it Fails 75-89, 94-95 (2001).


549 A comprehensive discussion is found in Schuck, The Limits of Law: Essays on Democratic Governance, supra note 428, at 187-95.

550 The different variations of Megan’s law, which are designed to provide timely information to the public on registered sex offenders residing in a specific area, follow this logic. See, e.g., The Jacob Watterling Crimes against Children and Sexually Violent Offender Registration Program Act of 1994, 42 U.S.C. § 14071.
information engenders market forces (e.g., a demand response) which subsequently induce the regulated entities to change their conduct.\textsuperscript{551} While the market is already in existence, this legislation is designed to increase the flow of information and thus improve the market’s operation.

Third, legislators may pass legislation in order to create a new market and commoditize a specific good in order to ensure socially-desirable level of production.\textsuperscript{552} For example, the Clean Air Act Amendments of 1990\textsuperscript{553} commoditized pollution rights (by introducing permits for clean air allowances) in an attempt to reduce acid rain.\textsuperscript{554} The road pricing proposal that the U.K.’s government recently put forward applies a similar logic. According to the proposal, a new legislation would introduce a pricing system that governs the use of road space. The proposal echoes the notion that “[t]he problem is not a lack of capacity, as most roads are empty most of the time, but rather the absence of an efficient system for allocating” the use of road space across time.\textsuperscript{555}

Fourth, legislators may pass a risk-management legislation that shifts, reallocates, spreads, imposes, or even magnifies particular risks with respect to the regulated entities. This type of legislation employs the idea that the changing the magnitude of risk affects ex ante incentives and behavior. Moreover, assuming all else remains equal, the changed magnitude of risk will induce the regulated entity to conduct itself in a way that minimizes its risk-exposure.\textsuperscript{556} Observations reveal that “[l]awmakers have frequently intervene [in risk-management], striving to reduce some types of risk outright and to reallocate numerous others.”\textsuperscript{557}

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The discussion presented in this Article is merely the beginning on a large and difficult set of problems. The thesis on legislative threats seems to have raised questions that deserve further study and analysis from both positive and normative perspectives. The emergence of invisible law, for example, and its effects on the formal legal system and its economies of scale and network effects, is one such matter. Another issue that lies at the heart of the matter is the manifold ways in which public officials, including

\textsuperscript{551} Cf. Kathleen Segerson, Mandatory vs. Voluntary Approaches to Food Safety, 15 AGRIBUSINESS 53 (1999) (when information related to food quality is available, market forces may create incentives for voluntary provision of food safety). Yet, this approach cannot be used in the presence of externalities, as when harm is inflicted on third-parties who do not participate in the market transaction.

\textsuperscript{552} Using market mechanisms may offer a superior regulatory strategy to strict command-and-control regulation. See W. Kip Viscusi & Ted Gayer, Safety at Any Price?, 25 REGULATION 54 (2002).

\textsuperscript{553} See PUB. L. NO. 101-549, 104 STAT. 2399 (1990).

\textsuperscript{554} Title IV of the Act also created a market for sulfur oxides as part of a program to cut their production in half. Rights to produce sulfur oxides were distributed to coal-burning power plants that then had the option of keeping them or trading them in the market to other producers. See Paul L. Joskow et al., The Market for Sulfur Dioxide Emissions, 88 AM. ECON. REV. 669 (1998) (discussing conditions necessary to ensure market’s success).

\textsuperscript{555} See Road Pricing: Driven to Radicalism, THE ECONOMIST, June 11, 2005, at 33.

\textsuperscript{556} Cf. Robert Cooter & Ariel Porat, Anti-Insurance, 31 J. LEGAL STUD. 205 (2002) (showing that whereas insurance spreads risk and erodes incentives, magnifying risk can strengthen incentives to reduce that risk).

\textsuperscript{557} See David A. Moss, When All Else Fails: Government as the Ultimate Risk Manager 292-96, 302-311 (2002).
legislators, can attempt to commit themselves to pursuing a stated social policy, and in the case of policy bargaining—to standing by their promises once these have been exchanged. The thesis also directs attention to the importance of the design of political policy-making institutions. In view of the intrinsic commitment problem, the question that merits additional inquiry is how these institutions should be designed so as to facilitate credible commitments and to bind lawmakers and public officials to their stated policies across space and time. Clearly, these issues implicate the cost-effectiveness of social control of behavior and therefore are bound to bear decisive impact on individual well-being and aggregate social welfare.

558 For a related discussion that focuses on enforceability problems that are associated with political transactions, see W. Mark Crain et al., Legislative Majorities as Nonsalvageable Assets, 55 S. ECON. J. 303 (1988).

559 Defining legislative organization as the allocation of resources and the assignment of parliamentary rights, Keith Krehbiel argues that forms of legislative organization bear directly on the performance of individual legislators and their legislative product (micro-level effects), and on the performance of the legislature within the political system and on how effectively does a legislation meet its policy objectives (macro-level effects). See generally Keith Krehbiel, Information and Legislative Organization (1991).

560 This important question has indeed occupied economists. See, e.g., Douglass C. North, Institutions and Credible Commitment, 149 J. INSTITUTIONAL & THEORETICAL ECON. 11 (1993) (examining the effects of institutional design on the credibility of commitments that are necessary to facilitate complex social contracts). See also Randall S. Kroszner & Raghuram G. Rajan, Organization Structure and Credibility: Evidence from Commercial Bank Securities Activities before the Glass-Steagall Act, 39 J. MONETARY ECON. 475 (1997) (certain internal structures can provide an effective commitment mechanism).