



Stanford Law Review

LEGISLATIVE THREATS

Guy Halfteck

LEGISLATIVE THREATS

Guy Halfteck*

This Article introduces a theory of legislative threats that not only pierces the fundamental construction of the legal system as a social regulatory institution but, more fundamentally, shows that the conventional wisdom on the role of the legal system in achieving and maintaining social order cannot explain how modern social control actually works. Contrary to received wisdom, the theory demonstrates that the threat of legislation—rather than legislation itself—plays a remarkable role in controlling behavior, in creating and setting incentives, and in maintaining social order.

Conceptually, legislative threats encompass threats that legislators exert on target entities—including banks and financial institutions, manufacturing corporations, professions, industrial sectors and trade bodies, universities and other public institutions, and federal agencies and U.S. states—according to which the legislator will exercise her legislative power and enact adverse legislation to regulate the conduct in question unless the threat recipients modify their conduct in line with the legislator’s demands. Implicit in the threat is the inverse promise that the legislator will forgo the threatened legislation if, and only if, threat recipients duly meet these demands. The Article examines ten case studies drawn from diverse areas of social policy, which demonstrate both the pervasive use of threats and their formidable regulatory capacity. The Article also offers an analytic taxonomy that delineates the conceptual boundaries of legislative threats and enhances the precision of the analytic inquiry: this taxonomy includes explicit, implicit, and anticipatory legislative threats.

The Article borrows tools and insights from the field of game theory to model the strategic interaction between legislators and target firms as a noncooperative game. This model yields clear and insightful predictions regarding the inducement effect of legislative threats—namely, the capacity of legislative threats to induce target entities to modify their behavior so as to avert the risk and consequences of the threatened legislation. The inducement effect, it is shown, depends on: (i) the credibility condition—namely, whether threat recipients believe that the threat is credible or, rather, mere “cheap talk”; and

* General Counsel, Solow Realty & Development Company, LLC, New York, New York. S.J.D., Harvard University (2003); LL.M., Columbia University (2000); LL.B., Hebrew University (1998). I wish to thank Alex Stein for his insightful comments, astute advice and unwavering support. I also wish to thank Jessica Eisenthal for her meticulous editing of this Article as well as the editors of the *Stanford Law Review* for their thorough review and excellent substantive comments and proposals. The opinions expressed in this Article—as well as any errors—are mine.

(ii) the effectiveness condition—that is, whether the perceived probability that the threatened legislation will be enacted into law is sufficiently high. The analysis also demonstrates how legislators’ commitments, reputation, and motivations affect the credibility of threats and, consequently, their inducement effect on the conduct of target firms.

Because threats are often directed towards groups as a whole (rather than to a single firm), the Article explains the counterintuitive effects of strategic interaction within groups on compliance with such threats (giving special attention to homogenous or heterogeneous as well organized or unorganized ones). In this respect, the Article develops the claim that compliance with legislative threats is, essentially, an informal political bargain in which a legislator barter the non-use of legislative power (with respect to a particular issue) in return for firms’ commitment to change their conduct. Thus, by focusing on bargaining in the shadow of legislative threats, the Article identifies two important, interrelated effects: (i) exerting legislative threats elicits valuable information from target entities, which in turn reduces transaction costs, facilitates efficient regulatory bargaining, and decreases the contractual incompleteness of the regulatory bargain; and (ii) regulatory bargaining provides an opportunity to craft superior measures that are necessary to effectively address the issues initially targeted by the legislator’s threat.

Overall, legislative threats encompass a powerful, innovative mechanism that legislators and regulators frequently employ as a means for exercising their institutional mandate to control social conduct and effect public policy. The emergence and prevalence of legislative threats therefore appear to be driven by the unprecedented functional challenges that modern legislators confront as they try to maintain social order in a highly dynamic social reality. Hence, this spontaneous solution seems to have emerged as a response to the functional limits of the law and the systemic failures of lawmakers. Further, the ever-increasing use of legislative threats represents a trend towards second-order social control where legislators, rather than dictating first-order rules of conduct, opt for second-order rules designed to create the incentives necessary to induce firms and groups to devise desirable social control measures on their own. Inevitably, this trend is bound to diminish the extensive role that the regulatory state has traditionally performed in directing social and economic life and, at the same time, increase the power of groups.

INDEX OF FIGURES AND TABLES	631
INTRODUCTION.....	631
I. THE CONVENTIONAL WISDOM ON SOCIAL CONTROL	639
II. LEGISLATIVE THREATS AS REGULATORS OF CONDUCT	645
A. Legislators and the Reality of Legislative Business	645
1. Cybersecurity	648
2. E-piracy.....	649
3. Digital obscenity	651
4. Executive compensation	651
5. Money laundering	652
6. Toxic-waste recycling.....	653
7. Greenhouse-gas emissions	654
8. Automobile air pollution	655

9. <i>Commercial leases</i>	655
10. <i>Illegal substances</i>	656
B. <i>An Analytic Taxonomy of Legislative Threats</i>	657
1. <i>Explicit legislative threats</i>	658
2. <i>Implicit legislative threats</i>	659
3. <i>Anticipatory legislative threats</i>	661
III. HOW DO LEGISLATIVE THREATS REGULATE SOCIAL CONDUCT AND INDUCE SOCIAL CHANGE?	663
A. <i>A Game-Theoretic Model of Legislative Threats</i>	665
1. <i>The rules of the game</i>	666
2. <i>The information structure of the game</i>	667
3. <i>The game's underlying assumptions</i>	668
4. <i>A game-tree representation</i>	671
B. <i>The Model's Predictions</i>	671
1. <i>Predicting the players' equilibrium behavior</i>	673
2. <i>Refining the predictions: Incorporating the notion of probabilistic threats</i>	675
3. <i>Extending the analysis to games with perfect and imperfect information</i>	680
IV. CREDIBILITY AND THE INDUCEMENT EFFECT OF LEGISLATIVE THREATS	687
A. <i>The Role of Commitments</i>	689
B. <i>The Role of Reputation</i>	692
C. <i>The Role of Emotions</i>	695
V. THE EFFECTS OF STRATEGIC INTERACTION WITHIN GROUPS ON THREAT- INDUCED COMPLIANCE.....	697
A. <i>Homogeneous Groups</i>	698
B. <i>Heterogeneous Groups</i>	701
VI. BARGAINING IN THE SHADOW OF LEGISLATIVE THREATS	703
CONCLUSION: THE LAW'S LIMITS AND THE CHALLENGE OF SOCIAL CONTROL	707

INDEX OF FIGURES AND TABLES

Figure 1. Extensive Form Representation of the Legislative Threat Game with Perfect Information and One Type of Threatened Legislation	672
Figure 2. Extensive Form Representation of the Legislative Threat Game with Perfect Information and Three Levels of Severity.....	682
Figure 3. Extensive Form Representation of the Legislative Threat Game with Imperfect Information and Three Levels of Severity	685

INTRODUCTION

As compensation gaps between corporate executives and rank-and-file employees widen, and as more public companies grant their senior officers stock option plans, bonuses, and severance benefits that appear to sever the hallmark link between pay and performance, executive pay has become a hotly contested political, economic, and regulatory issue. Responding to investor

concern over the lack of transparency of executive pay, the Securities and Exchange Commission (SEC) announced new rules in July 2006 that sought to tighten disclosure of executive and director compensation. The SEC relaxed the rules in December 2006, however, having been persuaded by business lobbies that the rules had the misleading—and hence undesirable—effect of inflating pay figures.¹ Responding to the SEC's move, Representative Barney Frank, the incoming chairman of the House Financial Services Committee, which oversees the SEC, announced he would push for stricter legislation. Sending an unambiguous signal to corporate America, Representative Frank proclaimed that “[b]acktracking by the SEC on this important matter of stock options reinforces my determination that Congress must act to deal with the problem of executive compensation that is now unconstrained by anything except the self-restraint of top executives, a commodity that is apparently in insufficient supply”² Making these public statements, Representative Frank not only expressed his dismay with the SEC's recent move and his concern over corporate America's compensation practices; he also laid out his legislative agenda, warning of the risk and consequences of the threatened, unfavorable legislation.

This story demonstrates the strategic use of *legislative threats*, an increasingly prevalent but virtually unnoticed modus operandi of legislators and regulators on both the national and state levels. Conceptualized in this Article, legislative threats encompass threats exerted by one or more legislators on firms (e.g., business corporations), professions, industrial sectors and trade bodies, universities and public institutions, federal agencies, and even U.S. states, according to which the legislator will exercise his legislative mandate and enact adverse legislation in order to regulate the conduct in question, *unless* the threat recipients alter their behavior to bring it in line with the legislator's demands. Implicit in the threat is the inverse promise that the legislator will forgo the threatened legislation if, and only if, the threat recipients duly meet such expectations. Under certain conditions, legislative threats induce entities to modify their conduct and abandon targeted practices, averting the risk and consequences of the threatened legislation.

As such, the concept of legislative threats describes a powerful mechanism to which legislators (and regulators) frequently resort as the means of choice for exercising their institutional mandate to control social conduct and effect public policy.³ Therefore, the inducement effect of legislative threats on

1. Siobhan Hughes, *SEC Reversal Irks a Committee Chief*, WALL ST. J., Dec. 28, 2006, at A2.

2. *Id.*

3. References to legislators and legislation include regulators and regulations, respectively. While important distinctions exist (e.g., authority, hierarchy, scope), they have no analytic bearing on the present arguments. Highlighting these distinctions will only reduce the high level of generality and broad applicability of the thesis. Unless otherwise

behavior explains ubiquitous instances in which firms announce what at a first glance may seem to be a voluntary adoption of socially desirable policies or a discontinuance of socially harmful practices.⁴

Yet, it is theoretically impossible and practically infeasible to reconcile this novel exposé with the conventional concept of the law (as a system of legal norms) or with the institutional role of lawmakers (as originators of legal norms). For instance, first-year law students are led to appreciate universal and fundamental truisms about the nature of the legal system and its role in maintaining social order.⁵ One conventional truism, or so it is taught, is that the legal system serves to control social behavior. Students are also taught that well-established sources of law, including *statutes* and *opinions*,⁶ are relied upon to control individual and organizational behavior.⁷ Inevitably, however, the theory of legislative threats calls into question the most fundamental notion of the legal system as a “coercive order of public rules addressed to rational persons for the purpose of regulating their conduct.”⁸

Strikingly, these seemingly universal truisms have not been theoretically questioned, nor subject to any rigorous scholarly inquiry. For this reason, and notwithstanding the credence that the conventional view has been afforded, the most fundamental question—namely, whether the conventional view descriptive of and coextensive with how modern social control *actually* works—has escaped critical examination.

noted, legislation and regulation are used interchangeably.

4. See, e.g., Bob Alexander, Letter to the Editor, *Options for House of Lords Reform*, TIMES (London), Feb. 6, 2003, at 21 (“[E]ither a statutory regulator or the threat of legislation hangs over [the profession] as an incentive to reform. Otherwise self-interest prevails”); James Moore, *SLI Urges Joint Action to Keep Boards True*, TIMES (London), Jan. 2, 2003, at 23 (“Trade bodies . . . released a new code of practice on shareholder activism . . . designed to head off the threat of legislation . . .”).

5. Maintaining order is the prime objective of groups and societies 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.” ROBERT ARDREY, *THE SOCIAL CONTRACT* 254 (1970).

6. See JOSEPH RAZ, *THE CONCEPT OF A LEGAL SYSTEM* 70 (2d ed. 1980) (“[B]y enacting statutes, making regulations, giving judgments, etc., norms are created.”).

7. The legal system employs various mechanisms to enforce rules and deter wrongdoing. See STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* 474-78, 571-90 (2004); see also CHARLES FRIED & DAVID ROSENBERG, *MAKING TORT LAW* 18 (2003) (“The preference for minimizing the sum of accident costs implies three principal functions of the legal system: optimal precautions, optimal insurance, and progressive distribution of the burden of funding the precautions and insurance.”).

8. JOHN RAWLS, *A THEORY OF JUSTICE* 207 (rev. ed. 1999). Coercive rules are addressed to rational persons and define the basic structure within which the pursuit of all activities takes place. *Id.* Accordingly, “[t]he first desideratum of a system for subjecting human conduct to the governance of rules is an obvious one: there must be rules.” LON L. FULLER, *THE MORALITY OF LAW* 46 (rev. ed. 1964).

I believe there are several reasons why this question has not been posed, let alone studied. In principle, Anglo-American legal scholarship focuses disproportionately on the judiciary, driven by the outdated assumption that courts are the prime social control agent in the legal system's overall design.⁹ Explaining this disproportionate scholarly focus on the judiciary, Richard Posner notes that it "started with Holmes's well-known characterization of the judge as an interstitial legislator, which Cardozo echoes in *The Nature of the Judicial Process*."¹⁰ Furthermore, even when legislation *is* the focus of the inquiry, the intellectual enterprise engages issues that lie on "the outer boundaries of the legislative process"¹¹ (e.g., statutory construction, normative constraints on legislative power), rather than on *how* legislation in and of itself serves to control social conduct. Moreover, the landscape of modern civil litigation reinforces the overemphasis of the judiciary's role: the confluence of large-scale cases and class action lawsuits in which judges and attorneys fashion complex global settlements¹² militates in favor of the view that courts, not legislatures, play a major role in modern social control.¹³ Echoing this view, commentators analogize class action settlements to ad hoc administrative agencies,¹⁴ and class action attorneys to lawmakers.¹⁵

Whatever the reasons for this failing, however, mounting evidence (presented and analyzed in Part II) warrants a systematic and rigorous treatment of the following question: does the conventional view of the legal system account for how modern social control *actually* works?

9. Cf. Mark Tushnet, *Legal Scholarship: Its Causes and Cures*, 90 YALE L.J. 1205, 1207-10 (1981).

10. RICHARD A. POSNER, *OVERCOMING LAW* 392 (1995). Posner further notes that "despite realist effort to refocus legal scholarship from the common law to the emergent world of statute law, legislation proved a challenge to which the realist tradition . . . was unable to rise." *Id.*

11. Edward L. Rubin, *Law and Legislation in the Administrative State*, 89 COLUM. L. REV. 369, 370 (1989) (discussing delegation, the void-for-vagueness doctrine, bills of attainder, and ex post facto legislation).

12. See William B. Rubenstein, *A Transactional Model of Adjudication*, 89 GEO. L.J. 371, 372-73 (2001) (asserting that (1) class action lawsuits are commercial transactions in which attorneys' activities are business oriented; (2) pleadings do not initiate adjudication but succeed the transaction's finalization; (3) judges broker deals—they do not adjudicate cases; and (4) the desire for nationwide and global deals displaces the boundaries of the judiciary).

13. See JACK B. WEINSTEIN, *INDIVIDUAL JUSTICE IN MASS TORT LITIGATION* 102-04 (1995) (noting that mass tort judges are involved in settlement discussions); Judith Resnik, *Managerial Judges*, 96 HARV. L. REV. 374, 378 (1982) (explaining that judges adopted an active, "managerial" approach according to which they negotiated with parties and worked beyond the public view and out of reach of appellate review).

14. See Martha Minow, *Judge for the Situation: Judge Jack Weinstein, Creator of Temporary Administrative Agencies*, 97 COLUM. L. REV. 2010 (1997).

15. See Bruce H. Kobayashi & Larry E. Ribstein, *Class Action Lawyers as Lawmakers*, 46 ARIZ. L. REV. 733 (2004).

The theory presented in this Article challenges the validity of the conventional wisdom, piercing the fundamental notion of the legal system as a regulatory mechanism and, more broadly, as a social governance institution. Contrary to this wisdom, this theory demonstrates that the *threat of legislation in and of itself*, rather than legislation, plays a remarkable role in controlling behavior, in setting underlying incentives, in maintaining social order, and in inducing change and effecting social policy. These theoretical insights subvert the long-standing premises on which modern legal systems rest, concerning, in particular, the role of legal norms in controlling activity across diverse social domains.¹⁶ In turn, this Article offers a positive theory of social control that is rooted in reality, rather than idealized premises and bygone truisms, thereby providing explanatory value and predictive power.

The theoretical inquiry implicates important societal interests and high social stakes because, as detailed below, legislative threats are used to control diverse activities, the consequences of which are vital to social welfare. For instance, legislative threats play a critical role in regulating environmental hazards, in reducing health risks, in enhancing consumer protection from product defects, in maintaining the security standards of Internet commerce and in lowering the risks of e-piracy, and in mitigating the risk of terrorist cyberattacks. Threats are similarly employed to reshape the responsibilities of corporate boards, induce banks and financial institutions to adequately monitor money transfers in order to detect money laundering and help deter organized crime, and to curtail the use of steroids and other illegal substances in professional sports. In sum, legislative threats are employed to effect a wide variety of welfare-increasing policy changes, the effects of which cannot be underestimated on either social welfare or policy grounds.

Puzzlingly, legislative threats have gone virtually unnoticed and remain unaccounted for on both theoretical and normative grounds despite their remarkably powerful regulatory power. This Article not only fills this gap in the current understanding of political institutions and policy-making dynamics, but also enriches the way in which we think about the complex inner workings of legislatures, the informal and less visible aspects of legislative business, and, most importantly, the dynamic and strategic interplay between regulators and regulated entities that shape and reshape the regulatory environment in which these entities operate. On the whole, the theory offers a sharp and compelling conceptual departure from the conventional wisdom on the law as a system of social governance and control.

Lest there be any doubt, legislative threats are not merely a conceptual novelty, one created by academic intellectualism and whose applicability is

16. An informal and unregulated source of “legal norms,” legislative threats are distinctly contrasted with the canonical sources of law described in JOHN CHIPMAN GRAY, *THE NATURE AND SOURCES OF THE LAW* (2d ed. 1921) and HANS KELSEN, *GENERAL THEORY OF LAW AND STATE* (Anders Wedberg trans., Russell & Russell 1961) (1945).

limited to the unruly world of ideas. Rather, the inquiry presented in this Article examines ten case studies that are drawn from diverse social contexts, shedding new light on legislators and legislative business. Moreover, these case studies demonstrate the pervasive use of threats and their regulatory capacity. These real-world observations therefore help decipher the subtle ways, often insufficiently visible to the public eye, in which legislators exercise their institutional mandate to control social conduct and make public policy. The combined weight of these cases lays down veritable conceptual foundations necessary to sustain one of the theory's key arguments—namely, that by exercising their age-old institutional mandate to opt out of the lawmaking process and employ legislative threats, legislators in fact effect social policy, produce norms, and induce regulatory changes in an entirely novel way.

Generalizing from these cases, the theory offers a novel and incisive account of the way legislators and regulators actually control social behavior, of the counterintuitive role the legal system plays in facilitating threats and in guiding conduct, and of the forces that work to shape the regulatory environment and societal framework in which social activities take place. Uncovering the use of threats, the theory posits that they introduce a *de facto* (albeit, not a *de jure*) source from which legal norms originate. As legislative threats become increasingly widespread across regulatory domains, an extensive “body” of norms—to which I refer as *invisible law*—will gradually emerge. This Article exposes this informal legal universe, where “norms” are crafted in the course of a dynamic and strategic interplay that is shaped by the threatened use of legislative power.

Unlike formal legal norms, informal legislative threats regulate conduct by *threatening* to use legislative power, not by *exercising* it. The unregulated use of threats may possibly pose normative challenges for the most celebrated hallmarks of American constitutional democracy including, primarily, the protection of constitutional rights and liberties, the separation of powers, and the decisional principles that determine the legitimacy and validity of legal norms.¹⁷ These potential concerns render the concept and workings of legislative threats all the more worthy of rigorous theoretical study.

Against this backdrop, a roadmap of this Article is in order. Part I provides a functional overview of the institutional arrangements in which legal norms

17. For instance, the use of legislative threats might arguably implicate “the precepts of justice associated with the rule of law.” See RAWLS, *supra* note 8, at 207. For, according to Rawls, “[t]hese precepts 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.” *Id.* (emphasis added). In any case, identifying and carefully assessing the normative implications—and, hence, the merits and social desirability—of using legislative threats to control social conduct and effect public policy requires rigorous analysis that, among other things, properly accounts for the inherent trade-offs that are associated with their strategic, regulatory capacity. Undertaking this analysis, however, lies beyond the scope of this Article.

are made. Part II develops the theory's conceptual, empirical, and analytical foundations. It first examines ten case studies and elucidates the regulatory function of legislative threats. Abstracting from these context-specific cases, the discussion offers an analytic taxonomy of *explicit*, *implicit*, and *anticipatory* legislative threats, which enhances the inquiry's analytic precision and delineates the conceptual boundaries of these types of threats.

Part III examines the economic machinations underlying legislative threats: how, and in what circumstances, are legislative threats expected to induce a change in the behavior of entities to which a threat is directed? In other words, under which conditions are threat recipients expected to comply with the legislator's demands? I borrow insights from game theory and model the strategic interaction between legislators and entities as a dynamic game in which legislators exert probabilistic threats.¹⁸ The probabilistic feature expresses the notion that executing a threat does not ensure the enactment of the threatened legislation: the legislator cannot guarantee that the threatened consequences will transpire, making the threatened legislation *probable* but never *certain*. Using game-theoretic methods, I use the model to predict how legislators and firms are expected to behave, showing the existence of two mutually exclusive predictions: *compliance* and *noncompliance*. This analysis unveils the potential *inducement effect* of legislative threats, which underlies their regulatory power.

The analysis shows that the inducement effect crucially depends on two conditions: (i) *the credibility condition*—whether threat recipients believe the threat is credible or, rather, mere “cheap talk”; and (ii) *the effectiveness condition*—whether the perceived probability that the threatened legislation will be successfully enacted is high enough to exceed a given threshold below which threat recipients will not comply, even though the credibility condition is met. In consideration of the latter, the discussion underscores the institutional, political, and reputational factors that influence legislative behavior in Congress and, hence, the probability of the threatened legislation. In consideration of the former, Part IV identifies circumstances that make threats credible and incredible, focusing on the role of three credibility-building mechanisms: pregame commitments, reputation, and emotions.

As legislative threats are most often directed towards groups—rather than to a single firm—Part V considers the effects on compliance of strategic interaction within groups (homogenous or heterogeneous, organized or unorganized). An entity's compliance (or noncompliance) decision is driven, in

18. For the sake of completeness, I extend the analysis to games with *perfect* and *imperfect* information, where the severity of the threatened legislation (i.e., lenient, moderate, severe) affects the target firm in *direct proportion* to the leniency, moderation, or severity of its terms. That the legislator may (but need not) reveal this information compounds the analysis but renders the model more descriptive of the actual legislative landscape.

part, by the compliance (or noncompliance, e.g., free riding, holdout) of other group members. Moreover, compliance may be used strategically to promote members' idiosyncratic interests. While strategic interaction may undermine compliance in some cases (e.g., predatory noncompliance), it may counterintuitively reinforce compliance in others (e.g., predatory compliance, raising rivals' costs, entry deterrence). The analysis develops a causal argument, showing that: (i) the issuance of a legislative threat and the prevalence of collective action problems reinforce the tendency of unorganized groups to organize; (ii) in-group enforcement mechanisms play a decisive role in ensuring group-wide compliance; (iii) group organization increases the likelihood of group-wide compliance and renders legislative threats more potent; (iv) legislators may (and often do) subsidize the cost of organizing; (v) the trend towards organization reduces transaction costs of bargaining, thus enabling legislators and group representatives to negotiate and design superior regulatory measures; and (vi) these effects further reinforce legislators' incentives to employ threats and a group's propensity to organize, thereby countering social and economic forces that contribute to the gradual weakening and disintegration of organizations.

In Part VI, I argue that compliance with legislative threats is, in essence, an implicit and informal political bargain in which the legislator barter the non-use of legislative power with respect to a particular issue in return for a firm's (or an industry's) commitment to change its conduct. Focusing on bargaining in the shadow of threats, two important effects are spotlighted: (i) legislative threats elicit valuable information and otherwise reduce transaction costs, facilitating efficient regulatory bargaining and decreasing contractual incompleteness; and (ii) bargaining provides an opportunity to devise functionally superior measures to address the social issues with respect to which the legislator initially directed the legislative threat.

The Conclusion argues that rapidly changing social conditions and increasingly complex social conduct drive societal instability. Paradoxically, absent effective social control, the processes that drive well-developed market economies towards economic growth and social progress may propel their economic decline, increase disorder, and lead to gradual societal deterioration. Thus, the more sophisticated and prosperous a society becomes, the more demanding is the lawmaker's role. Viewed from this perspective, the emergence of legislative threats is indicative of the increasing functional limits of the law and the rising institutional limitations of lawmakers. Legislative threats therefore embody the growing incapacity of the legal system to deliver its preeminent promise: maintaining ordered liberty and promoting sound public policies. Viewed from an even broader perspective, the pervasiveness of legislative threats reveals an increasing tendency towards a *system of second-order social control*, where legislators do not regulate actual conduct but instead strategically shape the incentives of entities and groups to adopt

desirable norms so as to avert the risk of legislation. Inevitably, the trend towards second-order social control diminishes the traditional role of the regulatory state but increases the power of legislators and groups.

The discussion is aimed at a broad audience as it advances existing knowledge and contributes to the literature in a number of fields, including social governance and control; regulation of business corporations, corporate self-regulation, and enforcement; political economy; and public choice and political science.

I. THE CONVENTIONAL WISDOM ON SOCIAL CONTROL

The theory of legislative threats is nothing short of a full-fledged offensive on the long-standing concept of the law and the conventional view of the legal system. A brief, functional overview of the legal system's perceived role in controlling social conduct is therefore an important and necessary backdrop.¹⁹ First, understanding the workings of social control is conducive to developing the theory of legislative threats and to appreciating its conceptual novelty. Second, this overview is essential in examining the functional effects, costs, and benefits of legislative threats vis-à-vis legislative measures. Third, this background is also germane in assessing the normative desirability of a legislator to resort to legislative threats—rather than to legislative measures—as a means to control behavior and advance social objectives.

19. The legal system only partially explains the observed social order, however. Human behavior and firm conduct are also governed by internal norms, mores, and values that may substitute or complement the legal system. Extralegal norms—including *private ordering* in the U.S. cotton industry, in New York City's diamond district, and on eBay's trading platform and *social norms* governing tipping and business practices—add an important dimension to social control. See generally Richard A. Posner, *Social Norms and the Law: An Economic Approach*, 87 AM. ECON. REV. 365 (1997) (defining social norms as rules that are neither officially promulgated nor legally enforced); Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328 (2004) (exploring ways in which parties enforce contracts without resort to public courts). For specific case studies of private ordering, see Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) (regulation and enforcement in New York City's diamond district); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001) (the arbitration system of farmers and cotton merchants); *Meg and the Power of Many*, ECONOMIST, June 11, 2005, at 65 (eBay's dispute resolution system). For specific case studies of social norms, see Ofer H. Azar, *The Social Norm of Tipping: Does It Improve Social Welfare?*, 85 J. ECON. 141 (2005) (arguing that U.S. restaurants' \$27 billion in annual tips enhances welfare) and Edward B. Rock & Michael L. Wachter, *Norms & Corporate Law*, 149 U. PA. L. REV. 1607 (2001) (explaining the role of norms in the corporate law context).

The legal system employs a coercive set of norms to define the basic societal structure within which the pursuit of all activities may take place.²⁰ While legislation accounts for a substantial part of the legal universe, norms also pour forth from other rulemaking and judicial bodies.²¹ The makeup of the legal universe therefore includes norms of different hierarchies (i.e., statutes, regulations, opinions)²² and norms of different types (i.e., rules, standards).²³ Operating in tandem, lawmaking and law enforcement guide the conduct of individuals, firms, and governmental bodies.²⁴

Relying on social control as its functional hallmark, the legal system is designed to provide the framework necessary to maintain the stability of social cooperation,²⁵ to facilitate market exchange,²⁶ and to achieve an efficient allocation of scarce resources.²⁷ Scholarly literature confirms that the law

20. Enforcement is necessary to maintain social cooperation and to prevent individuals and firms from sinking into the tragedy of the commons. This proposition, known as Hobbes's thesis, posits that effective enforcement serves as security between individuals. *See* DAVID P. GAUTHIER, *THE LOGIC OF LEVIATHAN: THE MORAL AND POLITICAL THEORY OF THOMAS HOBBS* 76-89 (1969); HOWARD WARRENDER, *THE POLITICAL PHILOSOPHY OF HOBBS* 30-47 (1957).

21. *See* E. ALLAN FARNSWORTH, *AN INTRODUCTION TO THE LEGAL SYSTEM OF THE UNITED STATES* 61-71 (3d ed. 1996) (discussing the hierarchy of legislative bodies).

22. *See* JANE C. GINSBURG, *LEGAL METHODS: CASES AND MATERIALS* 2-65 (3d ed. 2008) (discussing the origins, nature, and authority of case law and legislation). Opinions (i.e., particularized norms) count as legal norms although they originate from a lawmaking process different than that from which statutes emanate. *See id.* at 2.

23. Rules and standards serve different social-control functions as they differ in scope, level of generality or particularity, amount of information necessary to enforce them, scope of discretion, and degree of uncertainty (i.e., the level of outcome variability). *Cf.* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 *DUKE L.J.* 557 (1992) (evaluating the benefits of rules and standards). Exceptions and presumptions manage the tension between generality and particularity. *See* Frederick Schauer, *Exceptions*, 58 *U. CHI. L. REV.* 871, 872-73 (1991).

24. *See generally* Steven Shavell, *The Optimal Structure of Law Enforcement*, 36 *J.L. & ECON.* 255 (1993) (“[T]he actual pattern of enforcement seems to be broadly consistent with the pattern that is most effective in theory.”).

25. *See* RAWLS, *supra* note 8, at 207 (“[The] comprehensive scope . . . reflect[s] the fact that the law defines the basic structure within which the pursuit of all other activities takes place.”).

26. Norms may “commoditize” specific goods, thus creating a market for such goods. Absent systemic failures, this market may result in an efficient “commodity” distribution.

27. The indispensable role of the legal system in reducing transaction costs and in facilitating market exchange was theorized by Ronald Coase. *See* R. H. Coase, *The Problem of Social Cost*, 3 *J.L. & ECON.* 1 (1960); *see also* R. H. Coase, *The Firm, the Market, and the Law*, in *THE FIRM, THE MARKET, AND THE LAW* 1, 9 (1988) (“[F]or anything approaching perfect competition to exist, an intricate system of rules and regulations would normally be needed.”); R. H. Coase, *The Institutional Structure of Production*, in *ESSAYS ON ECONOMICS AND ECONOMISTS* 3, 11 (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.”).

facilitates market exchange.²⁸ For instance, empirical research on the depth, breadth, and resiliency of financial markets shows that markets are more developed in the presence of well-established legal norms that afford effective investor protection.²⁹

Institutionally, legal norms are made in three distinct setups: (i) norms produced by the state and its organs, including those enacted by the polity's legislature and promulgated by administrative agencies (e.g., statutes, regulations, ordinances, and orders); (ii) norms adopted by statutorily authorized self-regulatory organizations (SROs) pursuant to an explicit delegation of rulemaking power;³⁰ and (iii) norms created by judges in the resolution and settlement of large-scale litigation, which are commonly known as regulation through litigation.

Norms produced by the state make up a voluminous body of law and are heavily relied upon to control behavior across a wide variety of contexts.³¹ These norms originate from deliberative rulemaking processes of primary and secondary legislative bodies. These processes are transparent to the public eye, procedurally well structured, and governed by a set of rules that prescribe how valid norms are to be made. Functionally, these are designed to ensure that rulemaking adheres to legitimate decisional rules, provides sufficient opportunity to gather information (e.g., public comments), and enables meaningful deliberation and consideration (e.g., floor debate, committee hearings). Rulemaking power is not unlimited, however, since substantive and procedural constraints impose significant limitations designed to safeguard constitutional rights and liberties, prohibit retroactive application,³² guarantee

28. See Paul H. Rubin, *Legal Systems as Frameworks for Market Exchanges*, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 205 (Claude Menard & Mary M. Shirley eds., 2005).

29. See Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (finding that ownership concentration in public companies is negatively related to investors' legal protection); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) (showing that capital markets are less developed in countries with poorer investor protection).

30. Scholarly references to self-regulation are normally broader, covering a large number of self-imposed norms including those adopted by a household or a firm's management. See Anthony Ogus, *Self-Regulation*, in 5 ENCYCLOPEDIA OF LAW AND ECONOMICS, 587, 588-89 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000). These norms have no per se legal significance.

31. Documenting the increasing volume and importance of statutory law, Felix Frankfurter observed that "the work of the Supreme Court reflects the great shift in the center of gravity of law-making. . . . [A]s late as 1875 more than 40% of the controversies . . . were common-law litigation, fifty years later only 5%, while today cases not resting on statutes are reduced almost to zero. . . . [C]ourts have ceased to be the primary makers of law" Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 527 (1947).

32. See U.S. CONST. art. I, § 9, cl. 3 ("No . . . ex post facto Law shall be passed.").

rules' reasonable determinacy,³³ ensure that rules do not single out an individual or a group,³⁴ and invalidate a broad delegation of legislative power.³⁵

Turning to SROs: Trade associations, professional organizations, commodity markets, and securities exchanges (to name a few) are statutorily authorized to formulate and adopt rules. Highlighting their functional virtues, economists posit that SROs possess the most pertinent information and are well positioned to diagnose problems and devise efficient regulatory measures. They can establish effective compliance architectures,³⁶ and, compared with legislatures, may have stronger incentives to design socially desirable regulatory measures.³⁷ Seeking to secure these efficiency gains, legislatures set the regulatory objectives by statute but entrust the lawmaking and law enforcement tasks to an industry rulemaking body,³⁸ albeit not without procedural and substantive limitations.³⁹ Compliance with these rulemaking procedures and requirements is therefore a *sine qua non* of a legally effective rule⁴⁰ because self-regulation, while it may enhance social welfare, is also prone to self-dealing, opportunism, and other forms of rent seeking.⁴¹ Lastly,

33. See Jeremy Waldron, *Vagueness in Law and Language: Some Philosophical Issues*, 82 CAL. L. REV. 509, 536 (1994) (conceding that "there is some justice to [the] complaint" that vague norms are unfair because a citizen on whom the law is enforced becomes a victim of retroactive legislation); see also F.A. HAYEK, *THE CONSTITUTION OF LIBERTY* 152 (1960) (observing that an actor can use law "as the basis for his decisions"). A law and economics expression of this intuition is found in Richard Craswell & John Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. ECON. & ORG. 279, 279-83 (1986), which explains that individuals facing uncertainty may overcomply because the lower risk of liability gained by overcompliance may offset its cost.

34. Norms must be of general applicability; they cannot single out an individual or a group. See U.S. CONST. art. I, § 9, cl. 3; see also *U.S. v. Brown*, 381 U.S. 437, 442 (1965) (explaining that the rationale underlying the Bill of Attainder Clause is the separation of powers as a safeguard against trial by legislature).

35. Broad delegation undermines the notion of representative democracy. Cf. 1 LAURENCE H. TRIBE, *AMERICAN CONSTITUTIONAL LAW* 977-82 (3d ed. 2000).

36. To ensure compliance, enforcement actions of the Financial Industry Regulatory Authority include the expulsion and suspension of member firms. See, e.g., FIN. INDUS. REGULATORY AUTH., *FINRA STATISTICS 1*, <http://www.finra.org/Newsroom/Statistics/index.htm> (last visited Oct. 31, 2008).

37. See Adam C. Pritchard, *Self-Regulation and Securities Markets*, REG., Spring 2003, at 32, 33 (arguing that securities exchanges, not states, are more likely to optimize the tradeoff between investor protection and the cost of regulation).

38. See JOHN BLACK, *A DICTIONARY OF ECONOMICS* 422 (2d ed. 2002) (defining self-regulation).

39. SRO rulemaking must follow specific procedures and consider specific substantive factors.

40. Often, SROs must obtain the approval of a designated agency, such as the SEC, which must approve rules proposed by national securities exchanges.

41. Cf. CHRIS JAY HOOFNAGLE, *ELEC. PRIVACY INFO. CTR., PRIVACY SELF REGULATION: A DECADE OF DISAPPOINTMENT 1* (2005), <http://epic.org/reports/decadedisappoint.pdf>

SROs must effectively enforce their rules. Lenient or inadequate enforcement will cause suboptimal compliance, wear away the institutional advantages of SROs, and—assuming SROs adopt efficient rules—also involve a loss of social welfare.⁴² For this reason, SRO enforcement is subject to oversight and to the threat of government intervention.⁴³

Regulation through litigation has emerged in recent years as a new vehicle for regulating conduct, thus blurring the institutional allocation of regulatory and adjudicatory responsibilities between legislators and courts, respectively.⁴⁴ Specifically, the corporate defendants' vast liability exposure in mega-lawsuits involving asbestos risks,⁴⁵ tobacco,⁴⁶ gun injuries,⁴⁷ breast implant defects,⁴⁸ and lead paint exposure⁴⁹ worked as financial levers to impose broadly

(arguing that the FTC's Do-Not-Call Registry was successful in protecting consumer privacy, whereas privacy self-regulation on the Internet allowed firms to "obfuscate their practices").

42. I assume that SRO enforcement mechanisms operate efficiently in that the social cost spent on enforcement is lower than the social benefits gained from compliance. For this reason, lenient or inadequate SRO enforcement may result in social loss.

43. See Peter M. DeMarzo et al., *Self-Regulation and Government Oversight*, 72 REV. ECON. STUD. 687 (2005) (showing that SROs will choose a more lenient enforcement policy than customers unless the government monitors and intervenes, assuming SROs seek to maximize members' welfare).

44. See W. Kip Viscusi, *Overview*, in REGULATION THROUGH LITIGATION 1, 1 (W. Kip Viscusi ed., 2002). The interaction between litigation and regulation emerges because the economic rationales underlying regulation, including market failures (e.g., negative externalities, asymmetric information) also give rise to megalawsuits. *Id.*

45. The asbestos-related litigation induced the Occupational Safety & Health Administration and the Environmental Protection Agency to introduce a strict regulatory framework, thus creating strong incentives to reduce asbestos-related risks and injuries.

46. The Master Settlement Agreement with the tobacco industry is the most noteworthy example. The per-unit charges (essentially, an excise tax) imposed by the settlement on tobacco sales to future consumers were expected to award state plaintiffs \$229 billion over twenty-six years. See Craig L. Johnson, *The State of the Tobacco Settlement: Are Settlement Funds Being Used to Finance State Government Budget Deficits? A Research Note*, PUB. BUDGETING & FIN., Spring 2004, at 113, 116. The settlement also introduced (arguably anticompetitive) restrictions on advertising. David Cutler et al., *The Economic Impacts of the Tobacco Settlement*, 21 J. POL'Y ANALYSIS & MGMT. 1, 2 (2002).

47. The gun litigation involved lawsuits against the firearms industry, seeking to hold it liable for the cost associated with gun violence. See David Kairys, *The Cities Take the Initiative: Public Nuisance Lawsuits Against Handgun Manufacturers*, in GUNS, CRIME, AND PUNISHMENT IN AMERICA 363, 364 (Bernard E. Harcourt ed., 2003). A settlement could produce regulatory changes in safety devices and firearm distribution. See Phillip J. Cook & Jens Ludwig, *Litigation as Regulation: Firearms*, in REGULATION THROUGH LITIGATION, *supra* note 44, at 67-68.

48. The multibillion-dollar class action settlement did not introduce regulatory measures but played an important role in generating risk-related information that triggered the FDA's ban on implants. See Joni Hersch, *Breast Implants: Regulation, Litigation, and Science*, in REGULATION THROUGH LITIGATION, *supra* note 44, at 142-43.

49. See Randall Lutter & Elizabeth Mader, *Litigating Lead-Based Paint Hazards*, in REGULATION THROUGH LITIGATION, *supra* note 44, at 106-07 (concluding that litigation is a

applicable policy changes on entire industrial sectors.⁵⁰ However, these norms do not emanate from a publicly visible rulemaking process, thus usurping traditional legislative and administrative rulemaking mandates. Compared with legislation, regulation, and self-regulation, regulation through litigation involves very limited public input or expertise,⁵¹ and is subject to virtually no institutional accountability.

This phenomenon has been subject to criticism on the grounds that these norms disenfranchise constituencies and are inherently antidemocratic,⁵² an inevitable result given the institutional constraints within which courts operate.⁵³ Specifically, courts are not capable of taking into account diverse societal considerations that ought to shape regulatory choices.⁵⁴ They also lack the tools necessary to evaluate the impact—and, hence, desirability—of a given policy.⁵⁵ Similar limitations and rational self-interest bias the capacity of the parties to craft effective, socially balanced policies.⁵⁶ For, as publicly minded as plaintiffs' attorneys may be, they cannot—nor do they have incentives to—adequately represent competing social interests.⁵⁷ Even worse, such measures are likely to pass judicial muster despite their suspicious self-serving features.⁵⁸ Regulation through litigation is therefore viewed as an especially

poor institutional setup to address lead exposure).

50. *Cf.* Rubenstein, *supra* note 12, at 372 (noting that class settlements are transactions in which defendants purchase finality).

51. *See* Peter H. Schuck, *Why Regulating Guns Through Litigation Won't Work*, in *SUING THE GUN INDUSTRY* 225, 234-35 (Timothy D. Lytton ed., 2005).

52. James Wootton, President of the U.S. Chamber of Commerce Institute of Legal Reform, 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.” James Wootton, Introductory Remarks to Panel One: Litigation or Government Regulation?, at the Manhattan Institute Conference Series No. 2 (Feb. 2000), in *REGULATION THROUGH LITIGATION: ASSESSING THE ROLE OF BOUNTY HUNTERS AND BUREAUCRATS IN THE AMERICAN REGULATORY REGIME* 1, 2 (Ctr. for Legal Policy at the Manhattan Inst. ed., 2000), available at <http://www.manhattan-institute.org/pdf/mics2.pdf>.

53. *See* Lon L. Fuller, *The Forms and Limits of Adjudication*, 92 *HARV. L. REV.* 353 (1978).

54. *See* FRIED & ROSENBERG, *supra* note 7, at 94 (“[L]egislatures have the comparative advantage over courts in acquiring, evaluating, and acting upon the relevant expert information . . . needed for rationally and reliably determining the appropriate standard . . . and the mode of enforcing the standard.”).

55. Government regulation is preferable when policy decisions apply to a product line or market, for safety issues should be assessed on a product-wide basis. *See* W. Kip Viscusi, *Overview*, in *REGULATION THROUGH LITIGATION*, *supra* note 44, at 2.

56. Plaintiffs' attorneys and corporate defendants not only tailor settlement terms to promote self-interest, but also consider short time-horizons and less information than is necessary to design socially desirable regulation.

57. *See* Wootton, *supra* note 52, at 2 (noting that conflicts of interest affect attorneys' conduct).

58. Courts, generally, are vulnerable to subversion more than regulators, especially given the inequality in the distribution of wealth and political power in society. *See* Edward

troubling version of *regulatory capture*, wherein “regulators” are bridled by and serve the interests of those whose conduct they are expected to regulate.⁵⁹ Given these hindrances, regulation through litigation is bound to produce socially inefficient regulatory measures.⁶⁰

II. LEGISLATIVE THREATS AS REGULATORS OF CONDUCT

While legislative threats share the regulatory effect of legal norms inasmuch as they regulate conduct, they are anything but conventional legal norms. In fact, legislative threats present a novel regulatory mechanism, which controls behavior in an entirely different manner than that which underlies legal rules. Specifically, a legislative threat may have a formidable impact on the conduct of firms to which the threat is directed, inducing them to radically alter their behavior so as to bring it in line with the threat. Notwithstanding their potent regulatory impact, however, legislative threats do not emerge from a formal rulemaking process nor are they accompanied by a formal enforcement mechanism. Counterintuitively, their capacity to control behavior arises from the *absence* of any rulemaking product.⁶¹

Against this backdrop, Subpart A examines ten case studies that demonstrate the ubiquitous use of legislative threats. Subpart B offers a taxonomy of legislative threats, including *explicit*, *implicit*, and *anticipatory* threats, that enhances analytic precision and marks the concept’s outermost boundaries. This classification also generates insights necessary to explain the intricate mechanism underlying the inducement effect of legislative threats on behavior.

A. Legislators and the Reality of Legislative Business

We are accustomed to thinking about legislators in a rather straightforward fashion—namely, that benevolent legislators propose, craft, and enact

L. Glaeser & Andrei Shleifer, *The Rise of the Regulatory State*, 41 J. ECON. LITERATURE 401 (2003).

59. See Jean-Jacques Laffont & Jean Tirole, *The Politics of Government Decision-Making: A Theory of Regulatory Capture*, 106 Q. J. ECON. 1089 (1991). Regulatory capture is associated with distorted incentives, social welfare losses, and lower small business growth rates. See Irina Slinko et al., *Laws for Sale: An Empirical Study of the Effects of Regulatory Capture* (Mar. 2004) (CEFIR Discussion Paper), available at <http://ssrn.com/abstract=402840>.

60. Regulatory processes are not error-proof, however. See W. Kip Viscusi & James T. Hamilton, *Are Risk Regulators Rational? Evidence from Hazardous Waste Cleanup Decisions*, 89 AM. ECON. REV. 1010, 1012 (1999) (noting that since policy makers’ decisions are driven by risk perception biases, including anchoring and availability heuristics, regulatory target risk levels are inefficient).

61. This effect on behavior—the “inducement effect”—is analyzed and explained in Part III.B.

legislative measures in order to control social conduct and enhance social welfare.⁶² It is taken for granted that legislators debate and deliberate, hold committee hearings and plenary sessions, draft and redraft bills, form coalitions and negotiate terms, and exercise legislative power in order to effect a change in conduct,⁶³ and that the legislative process is designed to produce a formal legislative measure.

However, this rather simplistic and unrealistic representation fails on two counts—(i) the *public choice* count, and (ii) the *instrumental* count. First, legislators—and this is no secret or surprise—conduct their political business so as to advance their political self-interest and not necessarily the social good.⁶⁴ In many policy contexts, legislative initiatives and decision making cater to special interests and can only be explained by the steadfast pursuit of political and personal gain.⁶⁵ Second, assuming goodwill on the part of legislators, it still does not follow as a matter of strict logic that legislators will employ legislative measures as the instrument of choice to control conduct and maintain order; even benevolent legislators may resort to legislative threats in order to induce changes believed to promote the social good.

I argue that the inner workings of Capitol Hill, Parliament, or the Bundestag are far more intricate than what is ordinarily thought and commonly observed.⁶⁶ Counterintuitively, day-to-day legislative business is often

62. Rational-choice theorists argue that lawmakers do not necessarily exhibit a strong benevolent commitment to advancing social welfare. Rather, in advancing their self-interest, they often cater to special interests. See Peter T. Leeson, *How Much Benevolence is Benevolent Enough?*, 126 PUB. CHOICE 357 (2006) (claiming that absent an enforcement mechanism that punishes self-interest, “benevolence . . . is an ‘all-or-nothing’ proposition”).

63. Legislators are busy doing other things too, primarily raising funds necessary to cover the costs of electoral campaigns. See Richard Neustadt, *Foreword to the 2001 Edition of ERIC REDMAN, THE DANCE OF LEGISLATION* 8 (2001).

64. See Pierre Lemieux, *The Public Choice Revolution*, 27 REG. 22, 22 (2004) (noting that “[i]ndividuals, when acting as voters, politicians, or bureaucrats, continue to be self-interested and try to maximize their utility.”). That said, Senators and House Representatives may seek to promote benevolent preferences, partisan objectives, and self-interest. Hence, a policy measure that seems to reflect a public choice pathology may actually stem from prioritized preferences. See, e.g., Richard L. Revesz, *Federalism and Environmental Regulation: A Public Choice Analysis*, 115 HARV. L. REV. 553, 555 (2001) (“[D]ifferences [in state and federal environmental protection] stem from different levels of preference for environmental protection, rather than from public choice pathologies.”).

65. For a public choice critique of welfare economics see James M. Buchanan, *Politics, Policy, and the Pigovian Margins*, 29 ECONOMICA 17 (1962) (arguing that welfare economists ignore the political determination of social policies when analyzing the case for state regulation). See also Timothy Besley & Stephen Coate, *On the Public Choice Critique of Welfare Economics*, 114 PUB. CHOICE 253 (2003).

66. The complex inner workings of Congress have bewildered researchers, resulting in an incomplete understanding of how the institution functions. A former member of Senator Magnuson’s staff, Eric Redman, has observed that

[i]t was as if the academic community had looked at the glamorous and highly visible tip of an iceberg and declared that tip to be the iceberg; the other 97 percent of the

strategically designed to serve an ulterior objective: to avoid enacting a legislative measure altogether. In other words, the legislative process is frequently used solely to exert threats of impending legislation rather than to enact a legislative measure. Therefore, formal and observable legislation is nothing but the tip of the regulatory “iceberg” which also encompasses legislative threats and the ensuing body of *invisible law*—namely, informal, threat-induced regulation of social conduct.

The prevalence of legislative threats incorporates all areas of activity, ranging from cybersecurity and e-piracy to digital obscenity and air pollution; from executive compensation and money laundering to obesity and illegal substances. These threats provide an effective strategy to control the conduct of firms, organizations, professions, industrial sectors, and governmental agencies.⁶⁷ In some cases, threats of federal legislation have also been used to influence policy decisions of U.S. states.⁶⁸

The following discussion reports ten case studies that demonstrate how legislators work to achieve policy objectives and induce change. These cases illustrate how legislators and regulators strategically exercise rulemaking power

individuals . . . who support that tip, were simply left in the murky depths. . . . [A]nyone who knew the Senate would know that to ignore the role of staff is to ignore . . . Senate reality.

See REDMAN, *supra* note 63, at 17 (emphasis in original).

67. Moreover, legislative threats have also been directed towards federal and state agencies, inducing regulators to comply with the threat or face the risk of adverse legislation (e.g., stricter standards of review, revocation of delegation). See STEPHEN BREYER, *BREAKING THE VICIOUS CIRCLE* 41 (1993) (“Clean Air Act Amendments also provide a strict statutory standard . . . and . . . statutory ‘hammers’ designed to force EPA to promulgate standards for sources that fail to conform to the strict standard.”); Drew Edwards, *Bill Banning NCAA Sports Gambling to Reach Congress*, THE DAILY BEACON ONLINE, Jan. 30, 2001 available at <http://dailybeacon.utk.edu/showarticle.php?articleid=34058> (observing that the Nevada Gaming Commission recommended the gambling industry limit bets on college sporting events to \$550 in order to prevent consideration of threatened legislation by Congress); *Senate Democrats Back off Calls for Price Cap Legislation*, CNN.COM, June 19, 2001, <http://archives.cnn.com/2001/ALLPOLITICS/06/19/senate.energy/index.html> (observing that 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 in the West).

68. In a recent paper, Mark Roe reconceptualized the race-to-the-top theory of state competition in corporate law, arguing that Delaware’s “chief competitive pressure comes not from other states but from the federal government.” See Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588, 590 (2003) [hereinafter Roe, *Delaware’s Competition*]. Roe posited that “[w]hen the issue is [important], the federal government takes control of it or *threatens to do so*,” making Delaware legislators conscious that if they misstep, federal authorities could step in; and that this threat has conditioned Delaware’s behavior in shaping corporate law. *Id.* (emphasis added); see also Mark J. Roe, *Delaware’s Politics*, 118 HARV. L. REV. 2491 (2005) (explaining that interest groups dominating Delaware lawmaking forgo a winner-takes-all strategy, fearing federal legislators may act if results are lopsided). Enacted in response to governance failures in Enron and WorldCom, the Sarbanes-Oxley Act, Roe argues, demonstrates how Congress took over corporate law issues. See Roe, *Delaware’s Competition*, *supra*, at 590.

to exert threats, and in turn how these threats are used to regulate social conduct.

1. *Cybersecurity*

Officials from the Department of Homeland Security recently grew concerned with the inadequate security measures taken by the U.S. computer industry to make computer and network infrastructure sufficiently secure from the imminent risk of terrorist cyberattacks.⁶⁹ In response, DHS officials convened 350 computer executives and software developers to discuss these issues, share information on cyberattack risks, learn of the efforts currently undertaken, and evaluate possible solutions.⁷⁰ Having examined the nature of the problem, the officials *warned* the captains of the computer industry: either they step up to the plate and voluntarily align their practices with the standards the DHS considers necessary *or* the officials would seek to enact an adverse legislative measure, which would impose minimum security standards.⁷¹

The threat of legislation followed the government's *National Strategy to Secure Cyberspace*, a plan issued a year earlier to improve network security.⁷² Alas, as Silicon Valley executives related, "many specific propositions . . . were reportedly eschewed at the request of an industry hesitant to being forced to do anything."⁷³

Underscoring the threat, a DHS official stated that "[t]here are a lot of people out there willing to legislate *If that's what you want, that's what you'll get.*"⁷⁴ Computer industry executives were thus presented with a binary choice: they could either strictly comply with DHS demands *or* face the risk of

69. Expressing the security concern, Tom Ridge, the DHS secretary, said that "[i]t only takes one vulnerable system to start a chain reaction that can lead to devastating results." See John Markoff, *U.S. Pressing Industry on Technology Security*, N.Y. TIMES, Dec. 4, 2003, at C8.

70. The meeting took place at the DHS-sponsored National Cyber Security Summit and was attended by technology companies and industry trade groups. See *id.* As explained in Part V, the presence of trade organizations bears impact on an industry's incentive to comply.

71. *Id.* The proposed legislation would have also required companies to disclose their security status in financial filings because, presumably, poor security status would have been priced by the market, thus lowering firm value and stock price of such companies and increasing the cost of capital.

72. See DEP'T OF HOMELAND SEC., NAT'L INFRASTRUCTURE ADVISORY COUNCIL, THE NATIONAL STRATEGY TO SECURE CYBERSPACE 1 (2003), available at <http://www.whitehouse.gov/pcipb/>.

73. See Kevin Murphy, *Businesses Promise Security Plan by March 1*, COMPUTERGRAM INT'L, Dec. 5, 2003, <http://www.articlearchives.com/crime-law/criminal-offenses-cybercrime/180483-1.html>. 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.*

74. *Id.* (emphasis added).

adverse legislation and suffer its negative consequences. Showing that DHS officials got their point across, industry executives indicated that the “administration’s message had been unambiguous.”⁷⁵ Responding to the threat, four major business associations present at the Summit formed an industry-wide working group, aptly labeled the National Cyber Security Summit Alliance, and five specialized panels to study the problem, devise measures to reduce vulnerability, and develop a specific plan.⁷⁶ Vowing to have “initial deliverables” by a specific date,⁷⁷ the Alliance formation was the first significant step towards warding off the threat.⁷⁸

2. *E-piracy*

Electronic piracy is one of the least desirable offshoots of technological progress in an information-based economy.⁷⁹ In recent years, the prospect of e-piracy over the Internet has given rise to new regulatory concerns because piracy threatens to reduce Internet traffic, undermine e-commerce, impose significant antipiracy costs on businesses and consumers, and thwart consumer benefits from increased economic competition. In an attempt to address these concerns, the Federal Trade Commission’s threat to legislate e-privacy standards induced commercial Internet sites to self-regulate so as to protect consumers.⁸⁰

Responding to worries about the unauthorized sharing of digital media, in 2002 the Federal Communications Commission (FCC) tackled e-piracy in an effort to prevent piracy via digital TV. At stake was piracy of copyrighted content and unauthorized distribution of such content over the Internet. FCC

75. Markoff, *supra* note 69, at C8. A CEO 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.*

76. *See* Murphy, *supra* note 73. Microsoft, through its Chief Security Strategist, co-led the most important working group in charge of devising technological measures to secure the software that potential cyberterrorists would exploit, an effort which reveals Microsoft’s assessment of the harsh consequences of an adverse legislative measure for the industry as a whole and for Microsoft in particular. *See id.*

77. *See id.* (“It seems now the threat of legislation has kick-started things.”).

78. *Id.* (noting that the Alliance created a public-private self-regulation partnership).

79. The ability to mobilize and leverage critical information in real time—and the value of using such information in real time—had profound effects on business, including the emergence of real-time business models and the corollary trend towards managing business operations in real time. *See* THOMAS A. STEWART, *THE WEALTH OF KNOWLEDGE* 91-95 (2001). Other things remaining equal, managing business in real time tends to magnify the risk and cost of electronic piracy.

80. *See* Mary Mosquera, *FTC Threat to Regulate E-privacy Gets Real*, *TECH WEB*, May 30, 2000, <http://techweb.com/wire/29113467> (“The [FTC] had used the threat of legislation as a cattle prod . . . to get more commercial Internet sites involved in self-regulation.”).

regulators decided to mandate, as a minimum standard, the use of “broadcast flag” technology that was designed to prevent piracy of digital signals, and invited public comment.⁸¹ Showing that the FCC was keen on taking action, FCC Commissioner Michael Copps warned—in a statement that rendered the regulatory threat unambiguous—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.””⁸²

In fact, this threat followed an earlier one. Working with bipartisan cosponsors,⁸³ Senator Ernest Hollings, the Commerce, Science, and Transportation Committee Chairman, 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.”⁸⁴ According to the bill, the government would step in and mandate a solution if the industry did not reach an agreement within one year. Stating that the “private sector needs a nudge,” and that “the government can provide that nudge” and aiming to induce an industry-engineered solution, Senator Hollings circulated draft versions of the threatened legislation to threat recipients, which included high-tech companies and content producers.⁸⁵ Senator Hollings’ bill was introduced only after Commerce, Science and Transportation Committee hearings had been unsuccessful in reaching an agreed-upon solution.⁸⁶ During these hearings, media companies, including the Walt Disney Company, claimed that technology firms, such as Intel, derived gains from digital piracy. Once the threat had been issued, however, noncooperative behavior rapidly became cooperative and these companies began negotiating the standard technology in the shadow of the threat.

81. “A broadcast flag is a sequence of digital bits that could tell electronic devices not to play pirated content. With the technology, consumers could make copies for their own use but would be prevented from distributing copyrighted material over the Internet.” Stephen Chiger, *FCC Steps into Digital Copyright Debate*, PCWORLD.COM, Aug. 8, 2002, <http://pcworld.about.com/news/Aug082002id103739.htm>.

82. *See id.* (“The [FCC’s] decision represents new government pressure for industry groups to create a system on their own for digital rights management.”).

83. Cosponsorship may significantly enhance the credibility of the threat and its inducement effect.

84. *See Bill Would Prevent Sharing of Digital Music, Video*, USATODAY.COM, Mar. 22, 2002, <http://www.usatoday.com/tech/news/2002/03/22/digital-piracy.htm>.

85. *Id.*

86. *Id.* 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.*

3. *Digital obscenity*

Recently, the House Judiciary Committee's Copyright Subcommittee investigated a dispute that arose between the Directors Guild of America (DGA), a representative body of the U.S. movie industry, and a Utah-based consumer electronics manufacturer that marketed DVD players capable of editing out specific portions from films, thus enabling consumers to remove content they considered offensive.⁸⁷ The dispute arose because, arguably, editing out such materials violates artistic copyrighted content. Reinforcing the Committee's interest that the industry and the manufacturer end the dispute, the chairman threatened to introduce formal legislation to address these issues if the parties did not reach an agreement. The threat was 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 dispute resolved.⁸⁸ The threats induced Hollywood (notwithstanding the lawsuit it had filed to enjoin the violating conduct) to negotiate with the company in an attempt to reach a satisfactory solution and avert the risk of adverse legislation.

4. *Executive compensation*

The appointment, compensation, and removal of officers and directors are an important dimension of corporate governance in public companies.⁸⁹ The distorted correlation between pay and performance has attracted serious interest in the wake of the corporate fraud scandals that broke out in Enron and WorldCom (in the U.S.) and Parmalat (in Europe).⁹⁰ Classified boards and the ensuing insulation of management from removal have since been looked upon unfavorably.⁹¹

87. See Brooks Boliek, *DGA Skips D.C. Hearing*, HOLLYWOOD REP., May 20, 2004, available at <http://www.allbusiness.com/services/motion-pictures/4890639-1.html>.

88. *Id.* Lawmakers outlined various options for introducing legislation if the parties did not comply with the threat. See Brooks Boliek, *Tough Talk over ClearPlay*, HOLLYWOOD REP., May 21, 2004, available at <http://www.allbusiness.com/services/motion-pictures/4892301-1.html>.

89. See generally LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE (2004) (arguing that governance flaws enable managers to influence their pay, prevent boards from negotiating executive pay agreements at arm's length, and decouple compensation from performance).

90. For a comparative discussion of these corporate scandals see John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the U.S. and Europe Differ* (Columbia Law Sch. Working Paper Series, Paper No. 274, 2005), available at http://www.law.columbia.edu/center_program/law_economics.

91. See, e.g., Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 409-10 (2005) (observing that staggered boards, an arrangement that protects incumbent board members from removal, "are associated with an economically

It is precisely against this backdrop that investor rebellion over a £22 million payoff to the poorly performing CEO of GlaxoSmith Kline, and large payments to directors at the telecom company Marconi, notwithstanding the company's failures, led members of the U.K. Parliament to reckon that increased pay-performance sensitivity is needed.⁹² Pushing for reform, MPs directed a clear threat of legislation to public companies⁹³ that, if enacted, would have required companies to stop rewarding directors who failed to promote their shareholders' best interests.⁹⁴

Indeed, this threat changed the corporate landscape in Britain, forcing companies to reduce the length of directors' contracts and forge a close link between pay and performance. To ensure sustained compliance, the select 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."⁹⁵

5. Money laundering

Seeking to deter organized criminal activity, governments adopt measures to reduce benefits from committing such crimes, including bans on money laundering.⁹⁶ Given the machinations of money laundering, banks and financial institutions are the ultimate gatekeepers, for they are best positioned to monitor money transfers, detect suspicious activity, and report such incidents to enforcement agencies. Yet sanctioning institutions that fail to comply with antilaunching measures is difficult because it requires substantial information that is not readily available to enforcement agencies. For this reason, antilaunching has traditionally been governed by self-regulation.

meaningful reduction in firm value"). Empirical evidence confirms these concerns. See Marco Becht et al., *Corporate Governance and Control* 58-59 (European Corporate Governance Inst. Working Paper Series in Fin., Paper No. 02/2002, 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=343461 (updated August 2005).

92. Jill Treanor, *MPs Move to End Rewards for Failure*, GUARDIAN, Sept. 27, 2003, available at <http://www.guardian.co.uk/business/2003/sep/27/executivesalaries>. executivepay.

93. *Id.*

94. These concerns arose in the U.K. in the mid-1990s, as 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 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*, SUNDAY TIMES (London), Dec. 3, 1995, at 3.

95. Treanor, *supra* note 92. The Department of Trade & Industry stated 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.*

96. See *Money Laundering*, in A DICTIONARY OF ECONOMICS, *supra* note 38, at 305 (describing transactions and money transfers through financial institutions that conceal the ultimate source of money).

Alas, banking and financial institutions often fail to perform their role because preventing money laundering involves monitoring costs, training and personnel expenditures, and IT investment. Moreover, employing antilaunching monitoring crowds out certain high net worth customers.⁹⁷ It is no surprise that bankers and financial professionals may opt to turn a blind eye to their customers' activities, aiding in the camouflage of a suspicious source of money. Confirming this concern, the U.K. Treasury accused financial advisers of "willful blindness" to illicit funds and warned of the 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.⁹⁸

With the growing indications that banking, accounting, and law firms in the U.K. were complacent with respect to laundering, the U.K. government threatened to legislate if banks and financial institutions did not voluntarily devise and adopt a strict self-regulatory regime. Reinforcing the threat, the U.K. Treasury signaled it would consider a tougher approach to controlling the transfer of gains from criminal activity if the private financial sector would not step up to the task. To ensure wide dissemination, the government informed members of the British Bankers Association, the industry's trade association, of the strict policy objectives. Issuing the threat, the government demanded that the industry, which started to review its detection practices, provide the Treasury with revised plans for money laundering monitoring programs, and warned that if these proposals were determined unacceptable, the government would legislate and replace self-regulation with formal regulatory codes.⁹⁹

6. *Toxic-waste recycling*

The rise of environmental hazards focused legislative and administrative attention on policy concerns relating to the disposal of toxic materials, recycling of hazardous waste, and emissions of harmful gasses. The increasing interest in policy changes, coupled with the complex task of prescribing economically feasible measures, gave rise to widespread use of legislative threats on both the national and state levels.

97. 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 correlation between the effectiveness of antilaunching regulations and banks' compliance costs, focusing on the implications for bank-customer relationships).

98. *Legislation Threat to Banks' Self-Regulation*, PRIVATE BANKER INT'L, May 6, 1998, at 116 (reporting the government's concern over widespread money laundering and the financial sector's perceived complacency).

99. The government not only threatened to introduce strict legislation but also to end the traditional financial self-regulation. The risk of abolishing self-regulation augmented the risk of strict antilaunching legislation and the adverse effects of high compliance costs that the industry would incur.

For instance, the personal computers industry—which uses lead, mercury, cadmium, and other toxic metals to manufacture computers—has been the target of numerous legislative threats concerning the recycling of hazardous components. As environmental activists have repeatedly accused the industry of shirking their responsibility to safely dispose of these materials, state and national legislators realized that companies would not do anything meaningful unless they are required to. That has led legislatures to introduce proposed legislative measures in more than twenty states. Outside the U.S., the European Commission has also issued a draft directive with the goal of promoting the recycling and recovery of electronic waste.¹⁰⁰ As expected, “[t]he threat of legislation has PC companies . . . scrambling to come up with a system that is voluntary but still effective.”¹⁰¹ Companies have realized they are better positioned than legislators to devise effective solutions.¹⁰² Precisely to that end, manufacturers joined forces to form the National Electronics Product Stewardship Initiative, a working group designed to reach a consensus on hazardous materials recycling.

7. *Greenhouse-gas emissions*

The undesirable impact of greenhouse-gas emissions on global warming and on climate change more generally has occupied the Environmental Protection Agency’s (EPA) policy agenda for quite some time now. Accordingly, the EPA has collected data about the primary anthropogenic sources and sinks of greenhouse-gas emissions, which are key to studying the effects of greenhouse-gas emissions on climate change and to designing effective regulatory measures.¹⁰³

Specifically, in an attempt to reduce emissions in the semiconductor industry, the EPA threatened regulatory intervention. The threat of inopportune legislation induced the industry to enter into agreements with the EPA and commit to lower emissions.¹⁰⁴ Fearing the potentially intrusive and

100. See TechSearch International, *Motivations to Seek Lead-Free Alternatives*, in THE LEAD-FREE MOVEMENT: ENVIRONMENTALLY FRIENDLY ELECTRONIC MANUFACTURING (2000) (development of lead-free materials sparked by legislative threats in the United States, Europe, and Japan).

101. Crayton Harrison, *PC Industry Wary of Legislation on Recycling*, DALLAS MORNING NEWS, Aug. 8, 2002, at 1D. This article quotes a Gateway Inc. spokesman as saying, “[w]e’re talking, trying to come up with a way to [implement a voluntary PC parts recycling system].” *Id.*

102. Accordingly, PC makers were reported to have said that “a voluntary approach gives them more opportunity to find marketable ways to turn their industry green.” *Id.*

103. See ENVTL. PROTECTION AGENCY, INVENTORY OF U.S. GREENHOUSE GAS EMISSIONS AND SINKS: 1990-2006 (2005), available at <http://www.epa.gov/climatechange/emissions/downloads/08CR.pdf>.

104. Leading semiconductor manufacturers, including Lucent Technologies, Advanced Micro Devices, Hewlett-Packard, Intel, and IBM, have entered into such agreements with the

economically unfeasible requirements of the proposed regulation, business corporations seem to find refuge in agreements they negotiate in the shadow of the threat, which allow them to adopt environmentally responsible and cost-effective solutions. Echoing this notion, a Lucent Technologies official 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.”¹⁰⁵

8. *Automobile air pollution*

Low air pollution targets have been a long-standing environmental goal with respect to the auto industry. The reason for this has been the understanding that carbon dioxide, a greenhouse gas that cars belch into the atmosphere, causes undesirable climate changes. In 2004 it was discovered, however, 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 industry’s competitiveness, and harm the EU economy.¹⁰⁶ Responding to this untoward development, environmental groups demanded that the European Commission uphold previously set targets and advocated resorting to legislative threats to achieve environmental targets, reasoning that “[p]ast experience tells us that the threat of legislation is the best way to stimulate real improvements and technological innovations.”¹⁰⁷

9. *Commercial leases*

During the 1990s, the U.K. government grew concerned over unfair terms in commercial leases that placed business tenants under strict, potentially harmful obligations. Of particular concern was the upward-only rent review clause.¹⁰⁸ Responding to the government’s policy concern, in 1995 a cross-industry working group drafted a voluntary code of conduct containing twenty-three recommendations guiding landlords and tenants in negotiating commercial leases. Designed to promote flexibility and fairness, the code

EPA. Press Release, Alcatel-Lucent, Lucent Technologies Signs Voluntary Agreement with EPA (July 29, 1996).

105. *Id.*

106. The industry acted through a representative body, the European Automobile Manufacturers Association, which represented major manufacturers including Ford, General Motors, DaimlerChrysler, and BMW. Rob Edwards, *Car Makers Secretly Lobby EC to Reduce Air-Pollution Targets; Leaked Memo Reveals Pressure on Environment Commissioner*, SUNDAY HERALD (Glasgow), Mar. 21, 2004, at 6.

107. *Id.*

108. See Janet Higbee, *Commercial Property Law*, Cripps Alert (Cripps Harries Hall, Kent, England), Aug. 2003, available at <http://www.crippslaw.com/publications/commprop0803.pdf>.

addressed various issues, including assignment and subletting, rent reviews, insurance, default management, and dispute resolution.¹⁰⁹

As a nonbinding set of rules whose success depended on voluntary implementation by landlords and tenants, the code was largely ignored and failed to achieve its intended objectives. In 2001 the government responded with a threat of legislation, according to which minimum protections to the interests of business tenants would be enacted unless property owners and tenants devise a solution to introduce flexibility into commercial leases.¹¹⁰ Expressing the seriousness of the issue, the government imposed a two-year deadline after which voluntary code implementation would be assessed and appointed several bodies to monitor compliance with the threat.¹¹¹ This explicit threat engendered compliance with the code.

10. *Illegal substances*

The use of illegal substances in sports is another area where legislative threats have been employed to regulate conduct and promote desirable policy. In 2002 Representative John Sweeney introduced a bill to curb the use of steroid-like substances, but the proposed bill did not have much impact until the issue gained broad attention and threats to legislate were made explicit.

The use of performance-enhancing drugs by professional athletes started gaining significant attention on Capitol Hill after President Bush had denounced it in his January 20, 2004, State of the Union address.¹¹² In hearings before the Senate Commerce Committee and as congressional clamor intensified, senators pressured baseball officials to take actions necessary to stop the widespread use of such substances. Senator John McCain, the Commerce Committee chairman, explicitly warned officials that “he would begin looking for legislative remedies because ‘the status quo is not acceptable.’”¹¹³ Senator McCain later explained that holding high-profile

109. POLICY UNIT, ROYAL INST. OF CHARTERED SURVEYORS, A CODE OF PRACTICE FOR COMMERCIAL LEASES IN ENGLAND AND WALES (2d ed. 2002), available at <http://www.bpf.org.uk/pdf/16091/pub10194741883195-1.pdf>.

110. Angela Jameson, *Threat of New Law on Property Leases*, TIMES (London), Apr. 5, 2001, at 28 (“The property industry faces the threat of legislation to outlaw the lease at the heart of the UK’s commercial property market.”).

111. The government appointed Reading University to monitor and report the status of code implementation. The British Property Federation was appointed as well to monitor implementation on behalf of the property sector. See BRITISH PROP. FED’N, A CODE OF PRACTICE FOR COMMERCIAL LEASES IN ENGLAND AND WALES (2d ed. 2002), available at <http://www.bpf.org.uk/pdf/16091/pub10194741883195-1.pdf>.

112. Jim Puzanghera, *Congress Targets Sports in Crackdown on Steroids*, SAN JOSE MERCURY NEWS, Mar. 27, 2004, at 1A.

113. *Id.*

hearings had been an attempt to coerce the baseball league to act. The highly visible hearings signaled the seriousness of the threat.¹¹⁴

Contributing to the legislative dynamics, in 2004 Representative Jim Sensenbrenner, the House Judiciary Committee chairman, cosponsored a bill banning steroids, thus reinforcing public attention and augmenting legislative pressure on baseball officials.¹¹⁵ While Representative Sensenbrenner formally disagreed with Senator McCain's *explicit* threat to legislate, his bill was essentially an *implicit* threat. Accusing the baseball players' association of not responding to calls for tougher steroid testing, Representative Sensenbrenner stated, "I don't think that the players' union has gotten the message, but they're getting it."¹¹⁶

Responding to the legislative threat and the increasing squeeze from Congress, the Baseball Commissioner announced the baseball league had decided to ban the use of THG, a steroid that players use to evade detection in steroid tests.¹¹⁷ 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*

Abstracting from the previous case studies, this Subpart presents an analytic classification of legislative threats. In the interest of practicality and theoretical inclusiveness, it is neither context-specific nor ingrained in any particular legal system. Specifically, the taxonomy distinguishes between three types of threats: *explicit*, *implicit*, and *anticipatory*. This classification is not an intellectual exercise merely designed to enhance analytic precision and understanding; rather, a threat's taxonomical "type" is outcome determinative because it affects its inducement effect on behavior. For this reason, the taxonomy helps predict the likely effectiveness of a legislative threat in inducing a change in behavior. Moreover, the taxonomy delineates the

114. 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. Taking additional measures, the Food and Drug Administration ruled that THG was an illegal substance and Tommy Thompson, the Health and Human Services Secretary, publicly warned twenty-three companies to stop selling and marketing another steroid. *Id.*

115. See Press Release, Congressman Howard Berman, Berman Introduces Anabolic Steroid Control Act of 2004 (Mar. 1, 2004), available at http://www.house.gov/list/press/ca28_berman/Steroid_Control_Act.shtml (listing Rep. Sensenbrenner as a cosponsor).

116. *Congressman Criticizes Union*, SEATTLE TIMES, Mar. 23, 2004, at D9.

117. Puzanghera, *supra* note 112, at 1A. In addition to adverse legislation, Major League Baseball is subject to the risk that Congress—as was threatened in the past—might revoke its exemption from federal antitrust laws, which explains why "sports executives pay attention when Washington gets upset." *Id.*

phenomenon's conceptual boundaries and spotlights its seemingly disparate manifestations. It therefore allows for the inclusion of the less obvious *implicit* and *anticipatory* threats without which any account of legislative threats would have been limited to the more obvious *explicit* threats and would have therefore remained conceptually incomplete. Overall, this classification offers an analytic tool that lends itself to investigating the intricate landscape of social control, wherein formal legislative measures and informal legislative threats have a role in regulating social behavior.

1. *Explicit legislative threats*

Explicit threats are the quintessential manifestation of legislative threats. Their hallmarks include: (i) explicit communication of an unambiguous threat; (ii) articulation of a contingent legislative plan, typically laying out monitoring procedures and setting forth compliance deadlines; (iii) expression of a legislator's interest in controlling the conduct in question and the compelling case for the proposed reform; and (iv) disclosure of information about the threatened legislation.

An explicit threat is made when a legislator unambiguously communicates her intention to enact legislation unless the threat recipients comply with her demands. 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 threatened adverse legislation. In another case, the legislator circulated a draft bill to high-tech and media companies in an attempt to halt digital piracy.

While particular manifestations may vary, such threats have common characteristic features. The legislator normally reveals *substantial* and *unambiguous* information about his interest in controlling the conduct in question and spells out the social stakes that will likely be affected if a change in behavior is not achieved. Also he ordinarily expresses the social desirability of the reform that the threatened legislation is meant to achieve.¹¹⁸ In other words, explicit threats convey the legislator's unequivocal concern with the negative externalities of a particular conduct and his intention to exercise legislative mandate to remedy the problem.¹¹⁹ By exerting an explicit threat, the legislator *publicly commits* to pursuing the advocated reform by legislation in the event that threat recipients do not comply with his articulated demands.¹²⁰

118. The interest in controlling an activity is not necessarily imputed to the legislative body as a whole. Rather, it may relate to a few members of the legislative body or to one party.

119. Part III.B explains how information that legislators divulge signals the seriousness and credibility of the threat.

120. This commitment to enact adverse legislation is not necessarily believable,

Explicit threats typically espouse a contingent legislative plan,¹²¹ which will be executed *if, and only if*, threat recipients do not voluntarily modify their conduct. These often outline monitoring procedures and compliance deadlines, clarifying the steps and timeline that threat recipients must follow in order to avert the risk of legislation. For example, signaling the FCC's keen interest in curbing e-piracy, its 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."¹²² With respect to compliance procedures, the U.K. government's threat to legislate antilaundersing measures required that the financial sector provide the Treasury with revised monitoring programs which would then be reviewed by the government in order to ensure adequate compliance.

Nonetheless, explicit threats may differ with respect to the amount of information provided on the terms and features of the threatened legislation, potentially leaving a degree of uncertainty. While some legislators opt to describe it with specificity or have already introduced a proposed bill that reveals that information, others may disclose only general information. These observations confirm one's intuition that legislators strategically choose how much information to impart—in other words, what to make public and what to keep private—because revelation of pertinent information carries decisive strategic impact on the threat's effectiveness.

2. *Implicit legislative threats*

An implicit threat is inferred where the *actions* of legislators *signal* a legislative threat. In contrast to their explicit counterparts, implicit threats contain no public commitment, nor a contingent plan to enact legislation in the event that firms do not comply.¹²³ Accordingly, target entities face no demand to modify their conduct, nor are they warned that failure to do so will put them at risk of unfavorable legislation.¹²⁴ However, a public expression of interest in controlling the conduct in question is not inconsistent with implicit threats.

Consistent with other instances of unspoken behavior, implicit threats may arise from actions legislators take at different temporal junctures to further their

however. The conditions that make a threat credible or incredible are examined in Part IV below.

121. A threat may be made at different junctures of the legislative process. It may accompany a preliminary expression of the interest in legislation, a blueprint proposal, or a bill presented for plenary discussion.

122. Chiger, *supra* note 81 (internal quotation marks omitted).

123. A contingent commitment to legislate is the hallmark of explicit threats. *See, e.g.*, Jameson, *supra* note 110 (reporting that the U.K. Planning Minister would "impose legislation if a voluntary agreement is not reached").

124. Of course, an implicit threat may subsequently be formalized into an explicit threat.

policy agenda. Such signals may arise from: collecting relevant data; exchanging information with target entities or industry representatives; officially introducing a bill; and circulating drafts to targeted entities. The interpretation of such signals depends, *inter alia*, on information publicly available to target entities, which may be used to ascribe practical meaning to observed actions. For instance, a track record that establishes a legislator's reputation for using threats may render such actions particularly probative. The slow pace at which a legislator works to advance pending legislation may in certain circumstances be perceived as an invitation to comply with the implicit threat so as to dodge the risk of damaging legislation.

Because implicit threats are inferred, not communicated, uncertainty abounds.¹²⁵ In an attempt to resolve this uncertainty—and, indeed, to play it safe in case a credible threat is at issue—firms may choose to comply with perceived demands.¹²⁶ Staying the legislative process, even temporarily, in response to observed changes in conduct provides an unequivocal threat signal: it reveals a causal correlation between the threatened legislation and the industry's conduct.

Yet, why would legislators favor one type of threat over another?

An analysis of the underlying motivations reveals several factors that may affect the legislator's choice.¹²⁷ A legislator may avoid exerting an explicit threat so as not to put his reputation to the test. He may fear that failing to pass the threatened legislation will adversely affect his reputational capital, which is necessary in making credible (i.e., believable) political promises and threats.¹²⁸ Damaging his reputation, a legislator runs the risk of voter dissatisfaction, loss of campaign contributions,¹²⁹ and inability to extract future rents¹³⁰—all of

125. Analytically, uncertainty concerning whether an implicit threat has *already been made* is consistent with an implicit threat scenario, whereas uncertainty concerning whether a threat *will be made* in the future gives rise to an anticipatory threat, which is analyzed in Subpart II.B.3 that follows below.

126. See, e.g., Stephen Bell Wellington, *ISPs Get Code but Not Everyone Likes It*, COMPUTERWORLD, July 2, 2003, <http://computerworld.co.nz/news.nsf/news/CC256CED0016AD1ECC256D550080BB9D> (reporting that some members of New Zealand's tech community supported a voluntary "ISP code of practice" in order to stave off the threat of legislation).

127. A legislator's choice is by no means limited to explicit and implicit threats, nor is it confined to threats alone. The general choice between formal legislative measures and informal legislative threats, and the functional and institutional considerations that shape this choice, deserve in-depth analysis that lies beyond the scope of this Article.

128. Reputation guarantees cooperation between interest groups and legislators, since they cannot enter into enforceable fee-for-service contracts with each other. See Randall S. Kroszner & Thomas Stratmann, *Interest-Group Competition and the Organization of Congress: Theory and Evidence from Financial Services' Political Action Committees*, 88 AM. ECON. REV. 1163 (1998). The role of reputation in ensuring credibility is extensively discussed in Part IV.B *infra*.

129. See Randall S. Kroszner & Thomas S. Stratmann, *Congressional Committees as Reputation-Building Mechanisms*, 2 BUS. & POL. 35 (2000) (arguing that committees foster

which lower the chance of reelection. Moreover, the legislator knows that an established reputation for credibility is a valuable strategic asset that he can call upon to prompt compliance with future threats, thus further enhancing his reputation.¹³¹ This is why implicit threats, which involve no public commitment to legislate and no backlash for failing to enact legislation, are risk-free strategies.¹³² Furthermore, a legislator may use an implicit threat in order to avoid the political repercussions that an explicit threat may provoke from fellow lawmakers for what may be regarded as an illegitimate use of legislative power.¹³³

Assuming all else remains equal, these considerations militate in favor of implicit over explicit threats. But rarely do other things remain equal, for the choice between these threats is outcome determinative. Viewed from a legislator's perspective, the threat type affects the expected costs of exerting a threat but also strategically influences the inducement effect and benefits from employing that threat.

3. *Anticipatory legislative threats*

Anticipatory threats encompass instances in which no threat—explicit or implicit—has been made, but where a threat *may* be made in the future. These threats arise from a probabilistic anticipation that a legislator will make a threat at some point.¹³⁴ This notion involves a continuum of cases, including instances in which the odds are low (e.g., 20%) as well as instances in which they are high (e.g., 80%). The risk assessment may vary depending on the information available in each case.¹³⁵ Other factors affecting this risk include legislators' policy agendas, their track record of using threats, and the potential

repeated interaction between legislators and interest groups, and thus legislators must take account of their reputation in order to maximize political contributions).

130. See FRED S. MCCHESENEY, *MONEY FOR NOTHING* (1997) (arguing that special interest payments are often made not in return for political favors but rather to avoid political disfavor).

131. See KEVIN T. JACKSON, *BUILDING REPUTATIONAL CAPITAL* (2004) (arguing that a reputation for credibility, fairness, integrity, responsibility, or other virtues is a form of capital).

132. 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.”).

133. Normative concerns relating to the use of legislative threats as regulators of conduct—including, among other things, procedural safeguards, democratic unaccountability, and institutional legitimacy—will be the subject of future research.

134. Analytically, this risk includes potential threats as well as potential adverse legislation that will be sought without legislative recourse to threats.

135. This probability cannot be assessed when no information is available, leaving room for speculation and rendering the possibility of a future threat entirely uncertain.

consequences of the conduct in question. In this last case, the magnitude of the undesirable impact may provide a proxy for the visibility of the issue and for legislators' interest in using threats to regulate that conduct.

The magnitude of risk is an important determinant of a threat's inducement effect. Anticipatory threats may induce entities to comply with what they believe will be the threat's demands. Preemptive behavior modifications can lower the risk a threat will be made, thus avoiding the negative effects of threats on stock returns and firm value.¹³⁶

A demonstration of the inducement effect of anticipatory threats is found in the case of McDonald's, which announced in early 2004 its decision to phase out supersize portions in U.S. and U.K. restaurants.¹³⁷ Giant food portions, offering up to 50% more than a regular portion for just a few cents more, triggered waves of criticism as the debate over obesity's health risks gathered pace.¹³⁸ The release of *Super Size Me*, an award-winning documentary, further

136. Cf. Roger Beck et al., *Rent Extraction Through Political Extortion: An Empirical Examination*, 21 J. LEGAL STUD. 217 (1992) (demonstrating that Canadian firms suffered negative stock returns following announcement of potential adverse government action).

137. See Laura Peek et al., *McDonald's Takes Supersize Portions Off the Menu*, TIMES (London), Mar. 4, 2004, at 1; see also David M. Cutler et al., *Why Have Americans Become More Obese?*, 17 J. ECON. PERSP. 93 (2003) (arguing that the switch from individual to mass-prepared food lowered the time price of food consumption and led to an increased quantity and variety of foods). See generally Maria L. Loureiro & Rodolfo M. Nayga, Jr., *International Dimensions of Obesity and Overweight Related Problems: An Economics Perspective*, 87 AM. J. AGRIC. ECON. 1147 (2005) (surveying the factors responsible for higher caloric intake in OECD countries).

138. Obesity-related problems are associated with high social costs, including high healthcare costs. See, e.g., Jay Bhattacharya & M. Kate Bundorf, *The Incidence of the Healthcare Costs of Obesity* (Nat'l Bureau of Econ. Research, Working Paper No. 11303, 2005), available at <http://www.nber.org/papers/w11303> (arguing that obese workers tend to be sick more often and spend more on health care). In the U.S., for example, high obesity rates in certain socioeconomic classes are associated with lower productivity. See John Cawley & Sheldon Danziger, *Obesity as a Barrier to the Transition from Welfare to Work* (Nat'l Bureau of Econ. Research, Working Paper No. 10508, 2004), available at <http://www.nber.org/papers/w10508>.

Obesity is responsible for high social costs, both directly and indirectly. The increase in healthcare spending—regardless of whether the cost is born, in whole or in part, by the state—directly increases the total social costs associated with health maintenance and disease prevention. The increase in healthcare spending also has indirect effects on social costs: for example, higher healthcare spending implies that the healthcare system as a whole provides a higher volume of healthcare services. Assuming, among other things, that the increase in volume is not accompanied by a proportionate increase in healthcare service-providing capacity, higher volume might result in lowering the average quality of services provided to the population as a whole or might delay the provision of such services. Assuming that mortality rates increase when the quality of healthcare service deteriorates or when the length of delays increases, the overcrowding of the healthcare system due to higher obesity rates in the population has the indirect effect of increasing overall mortality and, therefore, the total social costs associated with operating the healthcare system. Similarly, lower worker productivity has the effect of increasing social costs for a number of reasons. Businesses may need to spend more resources on hiring and training new employees or on

increased the negative attention to McDonald's sales practices and their harmful impact on health.¹³⁹ Seeking to project a health-conscious corporate image and avert the risk of a legislative threat, the company's decision to alter its product line came out just as the U.K. government announced a national examination of public health and obesity.¹⁴⁰ Indeed, "the decision to scrap the supersize portion was only taken in order to avoid any threat of legislation which may harm the company."¹⁴¹ The McDonald's case belongs to a sweeping trend among food companies that, worried by a potential legislative threat, encourage well-being by offering healthier options and providing nutritional information for their products.¹⁴²

III. HOW DO LEGISLATIVE THREATS REGULATE SOCIAL CONDUCT AND INDUCE SOCIAL CHANGE?

The preceding discussion demonstrates the prevalence of legislative threats and offers an analytic taxonomy of threats pointing to, among other features, a legislator's publicly made commitment to legislate (explicit threats); the absence of a publicly made commitment to pursue a reform by legislation (implicit threats); and the risk of a future threat (anticipatory threats). Whichever threat is employed, however, casual observations confirm that legislative threats—including ones exerted by a single legislator—can induce a change in firm conduct.¹⁴³ Legislative threats therefore provide a powerful

retraining sick employees. In addition, the supply of products and services may be affected as well, imposing downstream costs including, for example, higher prices and delays.

139. The documentary chronicled the deterioration of the health of Morgan Spurlock, the filmmaker, over a month-long experiment during which he ate nothing but McDonald's food. See, e.g., A. O. Scott, *When All Those Big Macs Bite Back*, N.Y. TIMES, May 7, 2004, at E18.

140. This initiative was announced following a report that had been issued by more than 100 organizations, calling for "statutory controls to protect children from the promotion of 'unhealthy' foods." See Peek et al., *supra* note 137, at 1.

141. Kerri Dunne, *Mac's Will Not Be So Big in Ulster*, BELFAST TELEGRAPH, Mar. 5, 2004, <http://www.belfasttelegraph.co.uk/imported/mac-s-will-not-be-so-big-in-ulster-13665864.html>.

142. See Emma Duncan, *That Shrinking Feeling: Winning the Fight Against Flab*, ECONOMIST: THE WORLD IN 2006, at 93 (surveying actions taken by food companies to reduce products' caloric value).

143. See, e.g., Edwards, *supra* note 106, at 6 ("Past experience tells us that the threat of legislation is the best way to stimulate real improvements and technological innovations."); Bob McDowall, *UK Banking Competition—the End of the Regulatory Privileges for the Banks?*, IT-DIRECTOR.COM, July 3, 2000, <http://www.it-director.com/business/content.php?cid=1284> ("[T]hreat of legislation may be required to elicit changes" that enhance competition in payment systems.); Murphy, *supra* note 73 ("It seems now the threat of legislation has kick-started" the industry's effort to develop a cybersecurity plan.); *Senate Democrats Back Off Calls for Price Cap Legislation*, *supra* note 67 (noting that the threat of federal legislation to impose price caps on electricity induced the Federal Energy Regulatory Commission to extend price mitigation measures).

regulatory mechanism. What is more, the impact of threats on behavior is often superior to that achieved by enforcing formal legislative measures, even before taking into account the saving of significant expenditures on law enforcement.¹⁴⁴

In view of their prevalence, it stands to reason that legislators benefit from exerting threats and, furthermore, that these benefits exceed the costs undertaken by doing so. While malevolent legislators may benefit from employing threats as a means to extract political rents and campaign contributions,¹⁴⁵ benevolent legislators may benefit from promoting desirable regulatory policies.¹⁴⁶ Advancing desirable policies increases a legislator's utility inasmuch as it enhances political reputation, heightens constituent satisfaction, makes campaign contributions more probable, and improves the chance of reelection.¹⁴⁷ Rewards for benevolence may also include enhanced political visibility, thus further solidifying a legislator's reputational capital.

Whatever the benefits, no benefit may accrue *unless* the threat is believed to be credible. Threat recipients will remain indifferent unless they have a reason to believe that: (a) the legislator will carry out the threat if they do not comply; *and* (b) the expected cost of adverse legislation is greater than the cost of voluntary compliance.

Yet, precisely which conditions make legislative threats credible or incredible has no straightforward answer. Given the inherent intricacy of the political process, the answer is anything but intuitive. Confirming the perplexing features of the legislative process and its intrinsic uncertainty, Woodrow Wilson observed 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

144. The point here is that whereas enforcement is confined to deterring violations, firms' threat-induced self-regulation may result in a more efficient solution than the one a legislator could prescribe formally.

145. Paying rents essentially compensates the legislator for not exercising his power to charge individuals and firms for the right to keep capital they have amassed and wealth they have produced. See MCCHESENEY, *supra* note 130, at 86. Rents take many forms, including campaign contributions, speaking honoraria, and in-kind benefits. *Id.* at 45-53; see, e.g., Franklin G. Mixon, Jr., et al., *Rent Seeking and Hidden In-Kind Resource Distortion: Some Empirical Evidence*, 78 PUB. CHOICE 171, 172 (1994) (describing benefits including “trips, fancy meals or golf rounds”); Neil A. Lewis, *Medical Industry Showers Congress with Lobby Money*, 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 . . .”).

146. *Cf.* RICHARD L. HALL, PARTICIPATION IN CONGRESS 69 (1996) (noting that “legislative activism was related to liberal members' belief in federal action as an effective instrument for social betterment”); JOHN W. KINGDON, CONGRESSMEN'S VOTING DECISIONS 246 (3d ed. 1989) (“Most legislators have their conception of good public policy, and act partly to carry that conception into being.”).

147. Building a legislator's reputation increases his reputational capital, enabling him to make credible threats and derive additional benefits.

end there be.”¹⁴⁸ Moreover, one’s intuition and lay observations lead one to believe that threats and promises made by elected representatives are highly untrustworthy and cannot be afforded solid credibility.

How, then, do legislative threats induce a change in behavior and regulate social conduct? The following inquiry attempts to answer this key question. It aims to provide a rigorous theoretical account of the inducement effect and the elements affecting the threat’s effectiveness. This account reveals the factors that determine how effective a threat will be, thus allowing a precise prediction of the threat’s impact on conduct.

The analysis uses game-theoretic concepts and methods to investigate the strategic interaction between legislators and firms.¹⁴⁹ The discussion unfolds in the following manner: Subpart A models legislative threats as a dynamic, noncooperative game; Subpart B derives the model’s predictions and identifies the *sine qua non* conditions of a threat’s inducement effect.

A. A Game-Theoretic Model of Legislative Threats

I model the use of legislative threats as a noncooperative interaction in which legislators and firms make strategic decisions.¹⁵⁰ The predicted actions (strategies) of each of the players constitute the equilibrium. The strategy a player chooses crucially depends on what one player believes another player will do in a particular situation. The model constructed: (i) accurately outlines the rules of the game (i.e., how is it played, and who plays when); (ii) describes the game’s information structure (i.e., who knows what, and when does she know it); and (iii) explicitly states the underlying assumptions (i.e., what are the players’ preferences, and what do they care about).

The analysis begins with a simple yet realistic game, where the severity of the threatened legislation is fixed and known. I later extend the analysis to more complex situations in which the legislator chooses: (i) the severity of the

148. See WOODROW WILSON, CONGRESSIONAL GOVERNMENT 297 (15th ed. Houghton, Mifflin & Co. 1901) (1885).

149. Game theory is the discipline of economics that focuses on strategic interaction. It helps in understanding and predicting the parties’ behavior. The theory includes two branches: noncooperative and cooperative games. Noncooperative strategic behavior involves actions designed to increase the utility of one player while reducing it for the other. Cooperative games involve behaviors that increase (or decrease) the utility of all players. In a noncooperative game, players may take actions that, in common parlance, would be labeled “cooperative,” although such actions would be taken because they were in the best interest of each player singly. For a nontechnical primer, see DAVID M. KREPS, GAME THEORY AND ECONOMIC MODELLING 9-36 (1990). A more technical presentation of the subject is found in ROGER B. MYERSON, GAME THEORY: ANALYSIS OF CONFLICT 1-31 (1991).

150. A game consists of a list of participants (players); an array of possible actions for each player (strategies); rewards or losses for those actions for each player (payoffs); and a strict order of play. See AVINASH DIXIT & SUSAN SKEATH, GAMES OF STRATEGY 24-27 (1999) (defining strategies and payoffs).

threatened legislation (i.e., lenient, moderate, or severe); and (ii) whether to disclose it to the firm.

1. *The rules of the game*

At the outset, the legislator¹⁵¹ issues a threat to enact legislation that will adversely affect the targeted firm if it fails to voluntarily change its conduct in line with the specified demands.¹⁵² The threat implicitly includes a promise that if the firm complies, the legislator will forego or stay the threatened legislation. It is assumed that the severity of the threatened legislation is fixed and known. If enacted, the threatened legislation will negatively weigh on the firm in direct proportion to the severity of its terms. For instance, the legislation may impose strict standards of conduct, increase the funding and probability of enforcement actions for violations of existing laws (e.g., by providing strong incentives to bring suits), or raise fines and damages that make enforcement incentives stronger.¹⁵³ The negative impact on the firm may also transpire in the following ways: making business licenses harder to obtain, barring specific business practices, imposing measures that increase operational costs, increasing liability exposure and liability risk, enhancing competition in the market in which the firm operates, and reducing or capping prices charged for the firm's products.

Next, the firm decides whether to comply with the legislator's demands, or rather, to continue engaging in the same course of conduct.¹⁵⁴ Either way, the firm cannot decide the extent to which it will comply: compliance is indivisible.¹⁵⁵

151. For purposes of simplicity, I do not distinguish between threats made by one legislator, by a group of legislators acting through a congressional committee or otherwise, or threats made by a member of the executive branch of the government who could promote legislation. Assuming all else remains equal, these distinctions have no bearing on the model's predictions. Otherwise, comments are made.

152. The model focuses on a single threat recipient although this is not typically the case in real life—except, for example, when a threat is directed at an administrative agency or a megafirm that dominates the relevant market. *See, e.g.*, Puzanghera, *supra* note 112, at 1A (describing a threat directed at the baseball league); *Senate Democrats Back off Calls for Price Cap Legislation*, *supra* note 67 (describing a threat directed at a federal agency). Part V *infra* considers threats directed at numerous firms in an industrial sector or profession. *See, e.g.*, Markoff, *supra* note 69 (describing a threat directed at 350 industry executives of technology companies and industry trade groups).

153. The threatened legislator may create powerful incentives to enforce the law on targeted firms, subjecting firms to greater liability exposure and higher liability risks.

154. As explained in Part VI *infra*, a firm may either strictly comply or commence regulatory bargaining in the shadow of a threat in an attempt to reach a mutually agreeable solution.

155. While a firm can determine the magnitude of resources it will invest in compliance, what matters is not how much effort it makes but whether it complies or not. A legislator may choose to create an inverse link between the *severity of the threatened*

Subsequently, the legislator decides whether to carry out the threat. Carrying out the threat does not mean, however, that the legislator will be *successful in enacting* the threatened legislation; rather, all it means is that the legislator will *endeavor to enact* the legislation to the best of his political might. For this reason, exercising a threat creates the risk—not the certainty—that the adverse legislation will be enacted into law.¹⁵⁶ This fact suggests that legislative threats are probabilistic in nature, a feature that arises from the intrinsic uncertainty of the legislative enterprise.¹⁵⁷

2. *The information structure of the game*

The key questions in strategic interaction are: (i) how much information does each player know; and (ii) when does he know it. The game's information structure is important because the strategy a player chooses crucially depends on what one player thinks the other player knows.¹⁵⁸ I presently model a game with *perfect information*, capturing the idea that a player knows whose turn it is, as well as the exact stage the game has reached in the game tree.¹⁵⁹ Concretely, the firm can tell both that a legislator has issued a threat and what the severity of the threatened legislation is.¹⁶⁰ Even though a legislator *can* tell whether the firm is in compliance, she *cannot* directly observe the specific measures taken by the firm (e.g., enhanced internal controls, risk-reduction measures, or capital investment).¹⁶¹ Here, the underlying intuition is twofold.

legislation and the degree of observable compliance, making the negative impact of the threat contingent upon the *level* of compliance.

156. Probabilistic threats are commonly observed in the public international scene, where governments threaten probable infliction of economic harm. See DIXIT & SKEATH, *supra* note 150, at 302.

157. I defer discussion of this feature to Part III.B.2, where I will use it to refine the model's predictions.

158. In terms of information, games can be categorized as: (i) certain or uncertain games; (ii) games with perfect or imperfect information; (iii) games with symmetric or asymmetric information; or (iv) games with complete or incomplete information. For explanation, see ERIC RASMUSEN, *GAMES AND INFORMATION* 47-51 (3d ed. 2001).

159. Chess is a game of perfect information. When information about the other player's knowledge is not known, however, the game is one with imperfect information. *Id.* at 47-48.

160. A game also qualifies as one with symmetric information when one player has the same information as the other player. *Id.* at 49-50. In the present model, the legislator and the firm hold the same information. In keeping, I assume that both are equally well positioned to assess the probability that the threatened legislation will pass congressional muster and be enacted into law.

161. A more complex scenario is one in which a legislator cannot tell with certainty whether a firm has complied. Introducing this uncertainty into the model increases the analytic complexity but offers no new insights. In any case, in the presence of such uncertainty a firm will have to increase its investment in compliance in order to lower the risk that the legislator will erroneously carry out his threat. (This conclusion assumes rather intuitively that the higher the investment in compliance, the lower the risk of error will be.)

First, a legislator can monitor a firm's processes and output for compliance using testing, auditing, and agents to gather information;¹⁶² a legislator can check whether firms have reduced gas emissions or whether athletic organizations have tested baseball players for steroid use. Second, a firm has strong incentives to make its compliance known (but the converse is not necessarily true).

3. *The game's underlying assumptions*

The model rests upon several intuitive and realistic assumptions, which are explicitly stated and explained below.

Players' Rationality: Players are fully knowledgeable about the rules of the game; they are rational, meaning they seek to maximize utility;¹⁶³ and they are aware of each other's rationality. Hence, players' rationality is assumed to be common knowledge in the sense that players are aware of each other's rational decision making and utility-maximizing objectives.

The Legislator's Utility: Consistent with public choice theory, which posits that legislators conduct political business so as to advance political self-interest, a legislator's utility increases with his success in advancing socially desirable policies.¹⁶⁴ Strengthening political reputation—e.g., for toughness, fairness, or devotion to a policy stance—further increases utility.¹⁶⁵ Relying on empirical research in political economy, it is also assumed that constituents, political contributors, and fellow lawmakers reward good reputation and effort made to promote beneficial policies, but penalize failures and poor reputation. This, in turn, can enhance or degrade a legislator's reputational capital.¹⁶⁶ Lastly,

162. See, e.g., BRITISH PROP. FED'N, *supra* note 111 (noting that in accordance with the threat, the government appointed various bodies to monitor compliance by the property sector).

163. This assumption has the following practical meaning: every player maximizes his utility in the game given his opponent's strategies, every player is perfectly informed about the character of his opponents and the strategies they can play (and, if not, such uncertainty is understood and accounted for), and players are able to evaluate all their options. See KREPS, *supra* note 149, at 139 & n.3. Admittedly, individual behavior is often rational—namely, intendedly rational but only to a limited extent—or wholly irrational. See Herbert A. Simon, *Rationality in Psychology and Economics*, 59 J. BUS. 209, 223 (1986). For an overview, see generally RICHARD A. POSNER, *Behavioral Law and Economics*, in FRONTIERS OF LEGAL THEORY 252 (2001). Game theorists have developed different research strategies to capture the effects of bounded rationality in strategic interactions. See KREPS, *supra* note 149, at 154-56.

164. See Lemieux, *supra* note 64, at 22 (noting that as individuals, politicians continue to be self-interested).

165. See Kroszner & Stratmann, *supra* note 129; Kroszner & Stratmann, *supra* note 128.

166. See generally Randall S. Kroszner & Thomas Stratmann, *Corporate Campaign Contributions, Repeat Giving, and the Rewards to Legislator Reputation*, 48 J.L. & ECON. 41 (2005) (finding that greater reputational development has been rewarded with greater

investment of time, staff, and capital in a protracted legislative process decreases the legislator's utility insofar as it reduces time and resources available for fundraising.¹⁶⁷

The Firm's Utility: Any increase in net expected profits increases the firm's utility; conversely, increasing systematic risks such as the risk of costly legislation—which cannot be diversified away—decreases utility.¹⁶⁸ Specifically, exercising a threat decreases a firm's utility in two ways: (i) It reduces expected profitability, thus depressing stock returns and reducing firm value;¹⁶⁹ 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.¹⁷⁰

Self-regulatory organizations (e.g., NASD) and privately ordered industries (e.g., the U.S. cotton industry) will experience an additional decline in utility. This is because the threatened legislation may intrude upon their valuable self-regulatory privileges or limit their capacity to self-govern by private ordering.¹⁷¹ Here, the negative impact on utility is threefold: (i) The threatened legislation may introduce inefficient requirements (compared with those a firm may devise through self-regulation); (ii) the legislation may instate sweeping

political contributions to House of Representatives members during the period of 1983 to 1996). Using votes and contributions to reward good reputation reflects constituents' strategic and nonstrategic preferences for a good political reputation. The strategic derivation of this preference is rooted in herding behavior—namely, voters exhibit a preference for a good reputation because they believe others prefer a good reputation, too (perhaps as a result of a nonstrategic preference). Hence, when all else remains equal, reputable legislators have a higher chance of reelection. Fellow lawmakers may also reward good reputation (e.g., through higher cooperation) but penalize bad reputation (e.g., through political backlash). Hence, legislative threats and promises are not cost free.

167. See generally Neustadt, *supra* note 63.

168. Macroeconomic risks, including interest rates, exchange rates, and regulatory changes, are prime systematic risks. They are particularly undesirable because, unlike other risks, they cannot be reduced by diversification. A firm cannot guard against this risk by choosing different projects. For a definition of "systematic risk," see BLACK, *supra* note 38, at 455. While greater certainty facilitates planning and investment, systematic regulatory risks inhibit investment and reduce growth. See CHRISTIAN GOLLIER, *THE ECONOMICS OF RISK AND TIME* 32-34 (2001).

169. An event study using a sample of Canadian firms has shown that the announcement of potential adverse legislation negatively affects stock prices of firms covered by that legislation. See Beck et al., *supra* note 136, at 223-24.

170. Corporate finance research documents the "Congressional Effect," showing that stock returns are lower and 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 underway. See Michael F. Ferguson & H. Douglas Witte, *Congress and the Stock Market* 1-3 (2006) (Mar. 13, 2006) (unnumbered Working Paper Series), available at <http://ssrn.com/abstract=687211>.

171. See *Legislation Threat to Banks' Self-Regulation*, *supra* note 98, at 116 (noting that the U.K. government's threat to introduce antilaundering legislation put the long-standing tradition of self-regulation in the banking sector at risk).

regulatory reforms, going beyond that which is necessary to address the issue (i.e., a spillover effect); and (iii) the legislative intrusion may set a precedent, making future intervention more likely (i.e., a regulatory avalanche).¹⁷²

The Superiority of Self-Regulation over Legislation: Provided they adequately account for externalities, firms are best situated to regulate risk and conduct.¹⁷³ Compared with legislators, firms incur fewer costs in discovering the correlation between processes and outputs. This is due to the fact that firms, not legislators, are better informed of the source of the problem, its scope, and its possible solutions;¹⁷⁴ they are also better positioned to devise cost-effective solutions and policies for dealing with the very same concerns that legislators seek to address by means of legislation. Hence, threat-induced self-regulation offers a superior functional and cost-effective method for achieving the policy objectives underlying the threatened legislation.

The Repeated Nature of the Game: Both legislators and firms may repeatedly play the legislative threat game, though not necessarily against each other.¹⁷⁵ However, the only variable is each player's "history," which grows as time passes. Hence, both players are mindful of—and indeed care about—the fact that any move made in one game shapes their reputations and may have repercussions in other games.¹⁷⁶ This is why both players care about reputation building.

172. Cf. Jonathan Prynne, *Lloyd's Facing New Legal Controls*, TIMES (London), 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.").

173. The "uncertainties embedded in the regulatory process, and the assumptions the regulators must make in order to arrive at recommendations for actions despite those uncertainties" render risk regulation totally ineffective and inefficient. See BREYER, *supra* note 67, at 42. Moreover, problems emanating from tunnel vision, random agenda selection, and inconsistent risk-assessment methods make legislators virtually incapable of devising effective risk regulation. *Id.* at 10-29.

174. In contrast, members of Congress are typically thrust unprepared into a specialized milieu and are confronted with a massive volume of highly technical information, most of which they can deal with only superficially. See RAYMOND A. BAUER ET AL., *AMERICAN BUSINESS AND PUBLIC POLICY* 408-13 (1963). Moreover, committee members are rarely present or often disinterested. See Lynette P. Perkins, *Influences of Members' Goals on Their Committee Behavior: The U.S. House Judiciary Committee*, 5 LEGIS. STUD. Q. 373, 378-79 (1980) (noting that two-thirds of the House Judiciary Committee members hardly participated in regular meetings and deliberations).

175. A legislator's term in office limits the number of possible repetitions (hence, the finitely repeated nature of the game). However, a firm can repeat the game an infinite number of times because, theoretically, a firm can exist forever (hence, the infinitely-repeated nature of the game). See RASMUSEN, *supra* note 158, at 109-17. This difference has no immediate consequence except during the final game. *Id.* at 109.

176. Research shows that game repetition fosters reputation and cooperation. For example, zero-sum, one-shot games can turn into win-win games if continued in the long run. See generally Glenn Ellison, *Cooperation in the Prisoner's Dilemma with Anonymous Random Matching*, 61 REV. ECON. STUD. 567 (1994) (concluding that despite an inability to

4. *A game-tree representation*

Figure 1, shown on the next page, represents the game in *extensive form*, depicting the information structure of the game—what information every player knows at each juncture. Each node represents a “position” in the game, at which point a player must choose a strategy.¹⁷⁷ The arrows signify the available strategies. Any pair of numbers represents the payoffs received at the end of the game (i.e., utility gains or losses) by each player. In each pair, the legislator’s payoff appears first followed by the firm’s.

These payoffs embody how players evaluate possible outcomes. They reflect any gain or loss the players consider relevant to their utility—pecuniary or not. The firm’s payoffs reflect the cost of compliance¹⁷⁸ and the negative impact of the threatened legislation.¹⁷⁹ A legislator’s payoffs reflect the cost of pursuing the threatened legislation¹⁸⁰ and the benefits received if she is successful in inducing a desired change in conduct.¹⁸¹ By issuing the threat and making congressional and public appearances, a legislator can claim credit for achieving policy goals. In addition, by associating himself with the threatened legislation (e.g., by adding his name to the bill¹⁸²), a legislator may guarantee that if the threat is exercised and the bill is enacted, any accruing benefits will be internalized.

B. *The Model’s Predictions*

The discussion that follows below derives the model’s predictions and identifies the *sine qua non* conditions of a threat’s inducement effect.

tell who one’s opponent is in large populations, players cooperate in repeated Prisoner’s Dilemma games).

177. The first position in the game (i.e., in this case the issuance of the threat) is depicted by an open dot; filled-in dots represent subsequent positions.

178. The cost of compliance is 5. To comply, firms must incur fixed costs (e.g., installing technology). These costs do not change across firms (e.g., technology costs the same irrespective of firm-specific characteristics).

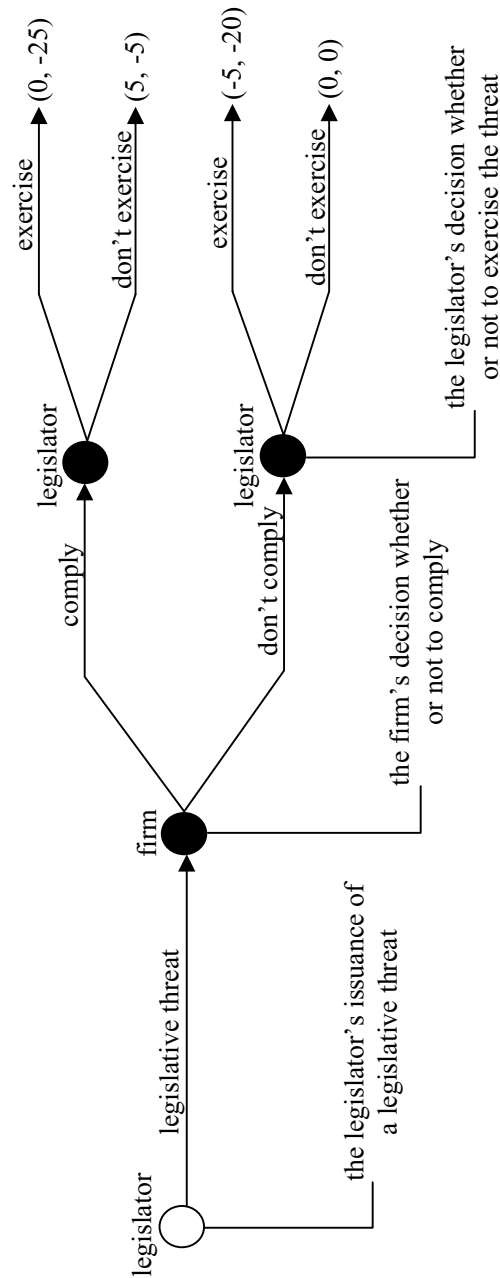
179. The negative impact of the threatened legislation is 20. This cost reflects expenditures the firm must incur and resources it must invest in order to comply with the new legislation (e.g., switching costs from one regime to another and investment in new systems).

180. The cost of drafting, introducing, and enacting the threatened legislation is 5.

181. The benefit from inducing the firm to change its conduct is 5.

182. This is a rather common practice. *See, e.g.*, Public Company Accounting Reform and Investor Protection Act (Sarbanes-Oxley Act) of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended at 15 U.S.C. §§ 7201-7266 and in scattered sections of 18 and 28 U.S.C.) (2006)).

Figure 1. Extensive Form Representation of the Legislative Threat Game with Perfect Information and One Type of Threatened Legislation



1. *Predicting the players' equilibrium behavior*

In order to derive the game's predictions, we must consider the following questions: First, faced with a legislative threat, will the firm comply or remain indifferent, and under what conditions will it do so? Second, upon learning of the firm's noncompliance, will the legislator carry out the threat or remain indifferent, and under what conditions will she do so?

Game-theoretic methods, in particular the Nash equilibrium, are used to generate predictions of what will ensue in the game. These predictions constitute the game's equilibrium (or resolution). The Nash equilibrium concept postulates that equilibrium behavior consists of a pair of strategies, one for each player. Each player's choice of strategy—his best response strategy—maximizes utility given the strategy the other player (who, too, chooses his best response) is expected to play. Provided players choose their best response, they have no incentive to play a different strategy. And, given the other player's strategy, no other strategy can make any of them better off. The intuition underlying this logic is as follows: if a strategy that maximizes one's utility is self-evident, and each player believes it is self-evident (and each player believes that the other player also believes it is self-evident), then each player must be choosing the strategy that is her best response to what the other player is evidently doing.¹⁸³ How, then, does the firm determine what is its best response? Quite simply, the firm compares the costs and benefits of playing a given strategy—namely, “comply” or “don't comply.” Seeking to maximize utility, the firm will choose the strategy that maximizes its benefits while minimizing its costs. This, by definition, is the firm's best response (or optimal) strategy. Yet, the firm's best response crucially depends on what the legislator is expected to do in response. Hence, the firm's best response is contingent upon the firm's belief as to whether the legislator will carry out the threat, if the firm does not comply. The firm's best response is also contingent upon the firm's belief as to whether the legislator will keep her promise to forego the threatened legislation, if the firm does comply. In sum, the firm's optimal strategy depends on whether the legislator's threat (and implied promise) is credible or, rather, incredible.

The threat is *incredible* if it is expected that when called upon, the legislator will *not* exercise the threat—even if the firm does not comply. In other words, the threat is mere “cheap talk.”¹⁸⁴ In this case, the firm's best

183. Nash equilibrium offers an appealing criterion for predicting players' actions. See DIXIT & SKEATH, *supra* note 150, at 82-83 (describing the Nash equilibrium solution). The Nash concept presumes that all players are fairly clear about what they and other players should do in order to maximize their utility. This “evident” course of action constitutes the equilibrium. See KREPS, *supra* note 149, at 28-32.

184. See DOUGLAS G. BAIRD ET AL., *GAME THEORY AND THE LAW* 65-66 (1994); KREPS, *supra* note 149, at 49-50.

response is “don’t comply” because, compared with the expected payoff for choosing “comply,” it maximizes the firm’s utility.¹⁸⁵ Stated differently, it makes no sense to incur compliance costs when the threat is incredible, because doing so would not benefit the firm. The firm’s choice is inconsequential because either way the risk of adverse legislation is zero. The Nash criterion mentioned above is satisfied because once the “don’t comply” strategy is chosen as the firm’s best response, the firm has no incentive to choose “comply.” According to this prediction—the *incredible threat equilibrium*—the firm does not comply with the legislator’s demands, and the legislator does not carry out the threat notwithstanding the firm’s noncompliance.

Conversely, the threat is *credible* when the legislator finds it is in her best interest (in the utility-maximizing sense) to carry out the threat if the firm does not comply. Similarly, the promise is *credible* if the legislator finds it is in her best interest to keep her word and abstain from instituting the threatened action if the firm complies. Given credibility, the legislator will carry out the threat if the firm fails to comply *but* he will keep his promise to avoid enacting the threatened legislation if the firm does comply. Credibility alters the picture dramatically. “Comply” immediately becomes the firm’s best response strategy; it maximizes the firm’s utility inasmuch as it spends relatively little on compliance in order to avoid altogether the risk and cost of unfavorable legislation.¹⁸⁶ This is so because once the firm chooses to comply with the legislator’s demands, he is best off not exercising the threat. In contrast, were the firm to have chosen “don’t comply,” it would have saved compliance costs but, at the same time, would have been subject to the risk and undesirable impact of the adverse legislation. Hence, credibility induces compliance with the legislator’s demands. According to this prediction—the *credible threat equilibrium*—the firm complies with the legislator’s demands, and the legislator keeps her promise and does not carry out the threat.

The foregoing analysis has generated two mutually exclusive predictions: the *credible threat equilibrium* and the *incredible threat equilibrium*. Practically, this analysis underscores the importance of credibility: Which of these predictions actually transpires depends on whether the threat (and implied promise) is credible or incredible.

185. A numerical analysis confirms this statement. Given that a legislator will not carry out the threat, compliance makes the firm worse off; it requires the firm to incur compliance costs of 5 in return for nothing. Whereas the payoff for compliance is (-5), the payoff for “don’t comply” is 0, thus showing that the “don’t comply” strategy makes perfect utilitarian sense.

186. A numerical analysis proves this point: Given a credible threat, it makes more sense to “comply” and obtain a payoff of (-5) than to play “don’t comply,” in which case the payoff is (-20). Hence, compliance is a firm’s best response because it ensures that the firm’s total utility loss will be limited to 5, whereas noncompliance would have resulted in a total loss of 20.

2. *Refining the predictions: Incorporating the notion of probabilistic threats*

In light of the unique properties of threats to use legislative power, these predictions merit further consideration. Recall that executing a legislative threat does not—and, in fact, cannot—ensure the enactment of the threatened legislation.¹⁸⁷ Hence, the legislator cannot guarantee that the threatened consequences will actually materialize. Rather, all that exercising the threat means is that the legislator will endeavor to enact the threatened legislation to the best of her political might; enacting the legislation into law is contingent upon factors other than the legislator's effort and will. For these reasons, the threatened legislation is at best *probable* but never *certain*.

In game-theoretic parlance, legislative threats are essentially *probabilistic threats* because they create the *risk* but not *certainty* of a dire outcome.¹⁸⁸ Carrying out the threat exposes the firm to the risk—but not the certainty—that the threatened legislation will become law. The probabilistic property of legislative threats is rooted in the intricacies of the political enterprise and uncertainties of the legislative process.¹⁸⁹

Incorporating the threat's probabilistic property into the analysis justifies a refinement of the model's predictions. In the case of the credible threat equilibrium, "comply" ceases to be the firm's clear-cut best response. Determining whether "comply" is indeed a best response depends on the probability that the threatened legislation will be enacted into law. A cost-benefit analysis indicates that when the threat is credible, compliance becomes the firm's best response *if and only if* the expected negative impact of the threatened legislation—which is equal to the loss in utility multiplied by the probability that the legislation will be enacted—exceeds the cost of compliance with the legislator's demands. In other words, the firm's cost-benefit analysis now takes into account these variables: (i) the cost of compliance; (ii) the probability that the threatened legislation will be enacted into law; and (iii) the utility loss brought about by the legislation. Mindful of this uncertainty, the

187. This would have become possible if political transactions were cost free. Had the legislator been able to engage in Coasian bargaining over policy, he would have been able to garner sufficient political support to enact the threatened legislation. *Cf.* Francesco Parisi, *Political Coase Theorem*, 115 PUB. CHOICE 1 (2003) (applying the Coase theorem to political markets).

188. *See* DIXIT & SKEATH, *supra* note 150, at 302, 451-54 (discussing probabilistic threats).

189. Compounding this uncertainty, legislators frequently engage in behind-the-scenes bargaining, consider the strategic implications of party voting, solicit proxies, make the effort to lobby committee members, and negotiate amendments with their opponents—all in order to influence the ultimate legislative product. *See* HALL, *supra* note 146, at 41-44.

firm's best response strategy is driven by the negative effect on utility of the legislation as it is discounted by the probability that it will not come to pass.¹⁹⁰

This refinement suggests that the inducement effect of legislative threats is qualified by an *effectiveness condition*—namely, a threshold probability below which a firm will not comply even though the threat is believed to be credible. Hence, credibility is a *necessary albeit insufficient condition* for inducing a firm to comply with a legislator's demands. Compliance can be predicted when two conditions are met: (i) the threat is credible; and (ii) the probability that the threatened legislation will be enacted exceeds the effectiveness condition. Unless these conditions are strictly met, the firm will remain indifferent and the legislator will be called to carry out his threat.

When considering the credible threat equilibrium in light of the effectiveness condition, two mutually exclusive predictions arise. First, when the probability that the threatened legislation will be enacted exceeds the effectiveness condition, it is predicted that the firm will comply and that the legislator will not exercise her threat. This prediction is labeled the *credible threat compliance equilibrium*. Second, when this probability falls below the effectiveness condition, the firm will not comply and the legislator will carry out the threat. This prediction is labeled the *credible threat noncompliance equilibrium*.

Clearly, this probability may vary from one case to another. It is therefore prudent for the firm to assess this probability so as to choose its best response strategy wisely. The firm can gather data and analyze relevant information to gauge the likelihood of both favorable and unfavorable voting scenarios in the House and Senate.¹⁹¹ Specifically, given the inherent intricacies of the political process, a variety of institutional, political, and reputational factors may influence legislative behavior in Congress and affect the likelihood that the threatened legislation will be enacted. The composition of the House and the Senate, for example, is one significant determinant. In addition, the

190. A numerical analysis confirms this point. Compliance costs the firm 5. If the firm does not comply and the threatened legislation is enacted, the firm suffers a loss of 20. Yet, if there is a chance that the legislator will not succeed in enacting the threatened legislation, the firm's expected loss will be *proportionately* lower than 20. In this case, 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%. This is because risk exposure decreases a firm's utility and, hence, a firm will comply even if only to avert the 25% chance of adverse legislation. Cf. Ferguson & Witte, *supra* note 170 (noting that legislative activity in Congress is correlated with lower stock returns, consistent with the hypothesis that regulatory uncertainty reduces firm value). In all other cases, it makes sense to do nothing because the expected loss in utility is lower than the cost of compliance.

191. Although 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 involved in carrying out the threat (e.g., higher potential to damage reputation), the stronger the incentives a legislator will have to make an effort and increase the chance of enacting the legislation.

membership and control of the relevant congressional committee is an overwhelmingly important factor that can make or break the threatened legislation.¹⁹² Diverging partisan preferences concerning the issue are also important.¹⁹³ Lastly, to the extent it is observable to entities outside the political arena, logrolling (i.e., vote-exchange agreements) also shapes the firm's probability assessment and, hence, its best response.

Cosponsorship—which has been aptly dubbed “one of the lubricants of the legislative process”¹⁹⁴—is another factor likely to increase the probability of the threatened legislation. A solicitation for cosponsorship carries an implicit offer that in return for the cosponsor's support, the soliciting legislator may give the cosponsor an opportunity to share the much-needed political credit and publicity associated with the bill. Cosponsorship therefore provides a medium for political exchange, which enables the legislator to collaborate with one or more cosponsors and thereby guarantee sufficient support in favor of the threatened legislation.¹⁹⁵

These factors are but a few of those bearing on the probability of the threatened legislation. Other factors that may also play a significant role include: political reputation and established track record; legislators' identification with social groups;¹⁹⁶ special interests and legislative capture; the extent to which a party controls its members' voting; public opinion on the issue in question and its impact on policy making;¹⁹⁷ and whether the threat is explicit, implicit, or anticipatory.

192. Political parties appoint members to congressional committees. In making these decisions, they consider how the membership of the respective committees may affect bills pending before the legislature. John R. Boyce & Diane P. Bischak, *The Role of Political Parties in the Organization of Congress*, 18 J.L. ECON. & ORG. 1 (2002). The composition of congressional committees is an especially important factor. Because committees have the mandate to set the agenda, they are able to enforce their policy preferences, to originate bills, and to shape the terms of the proposed bill after their chamber has worked its will. See Kenneth A. Shepsle & Barry R. Weingast, *The Institutional Foundations of Committee Power*, 81 AM. POL. SCI. REV. 85 (1987).

193. Cf. David Epstein, *Partisan and Bipartisan Signaling in Congress*, 14 J.L. ECON. & ORG. 183, 199 (1998) (noting that bipartisan policy making is preferred when partisan differences over a particular policy preference are minor).

194. REDMAN, *supra* note 63, at 78.

195. *Id.* at 79; cf. Barry R. Weingast & William J. Marshall, *The Industrial Organization of Congress; or, Why Legislatures, Like Firms, Are Not Organized as Markets*, 96 J. POL. ECON. 132, 142-43 (1988) (arguing that, given bargaining problems in legislatures, specific forms of nonmarket exchange are necessary).

196. Research finds, though not without controversy, that a legislator's policy interests and the intensity of his preferences are related to his personal identification with particular social groups, defined by race, ethnicity, gender, and age. HALL, *supra* note 146, at 70-71, 190-94.

197. 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]

A legislator is rationally interested in securing a firm's compliance in order to avoid incurring the cost of carrying out a threat.¹⁹⁸ Compliance maximizes the legislator's utility and makes her better off.¹⁹⁹ In order to ensure compliance, however, the legislator must guarantee that it qualifies as the firm's best response. In theory, the legislator may shape the firm's cost-benefit calculus by: (i) relaxing his demands so as to lower the firm's compliance costs; (ii) making the legislation's undesirable impact harsher; and (iii) striving to raise the probability of successfully passing the threatened legislation, making it greater than (or at least equal to) the effectiveness condition.

Relaxing the demands and lowering the cost of compliance are undesirable from the legislator's utility-maximization perspective.²⁰⁰ Intensifying the severity of the threatened legislation²⁰¹ is similarly unattractive.²⁰² The intuition here is that the harsher the threatened legislation is, the more implausible—perhaps impossible—it will be to enact it into law, unless a substantive compromise is made. This highlights the existence of an inverse correlation between the *severity* and *probability* of threatened legislation.²⁰³ For this reason, increasing the severity of the threatened legislation may proportionately lower its probability of enactment. And, because the expected negative impact remains virtually unchanged, increasing the severity will have no bearing on the firm's incentive to comply.

Working to increase the probability of threatened legislation to the point at which it exceeds the effectiveness condition—or, rather, attempting to convince the firm that the probability is higher than it actually is—emerges as the best strategic option. Increasing the probability will satisfy the effectiveness condition and induce the firm to comply with the legislator's demands. Here, logrolling provides one way in which a legislator can guarantee (or increase the

put forward the idea a year ago.”).

198. Here, it is implicitly assumed that carrying out a threat if and when called to do so is in the legislator's best interest, thus ensuring the threat's credibility.

199. Figure 1 shows that whereas the payoff for exercising a threat is (-5), the payoff a legislator receives if a firm complies is 5. Compliance increases a legislator's utility by 10 units.

200. Giving the firm partial relief from an earlier demand to modify its undesirable conduct is bound to reduce a legislator's benefits from promoting social change.

201. The 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, and more effective enforcement contribute to increasing the level of severity.

202. It is implicitly assumed that a firm becomes aware of these changes because information privately held by a legislator cannot influence a firm's decision making.

203. This correlation is driven by several factors. First, harsher legislation creates antithetical policy stands, making a consensus harder to achieve. Second, harsher legislation involves serious economic consequences, making it worthwhile for targeted firms to lobby against the legislation so as to render it less probable.

likelihood of) sufficient political backing for the threatened legislation and thus a higher probability of its enactment.²⁰⁴

In an attempt to raise the legislation's chance in Congress, a legislator may trigger an *availability cascade*—namely, a “self-reinforcing process of collective belief formation by which an expressed perception triggers a chain reaction that gives the perception increasing plausibility through its rising availability in public discourse.”²⁰⁵ Applied to the present context, a legislator can make an effort to educate the public of the social importance of the underlying issues and work to change public opinion in favor of the advocated reform. This way the legislator may be able to garner the political support necessary to pass the threatened legislation, taking advantage of the fact that Congress acts in response to changes in public opinion more than two-thirds of the time.²⁰⁶

“Brinkmanship” is another tactic a legislator may employ in order to increase the likelihood of enacting a threatened legislation.²⁰⁷ In game-theoretic parlance, *brinkmanship* is the creation and gradual escalation of the risk of the threatened consequences.²⁰⁸ Applied to this context, a legislator can take various actions that gradually and steadily raise the likelihood of the threatened legislation, continuing all the way to the point at which the probability is equal to (or greater than) the effectiveness condition.²⁰⁹ In order to serve their purpose, however, these actions must be common knowledge: the

204. See Francesco Parisi, *Votes and Outcomes: Rethinking the Politics-Like-Markets Metaphor*, 13 EUR. J.L. & ECON. 183, 185 (2002) (arguing that logrolling and political bargaining increase the predictability of the outcome); Thomas Stratmann, *The Effects of Logrolling on Congressional Voting*, 82 AM. ECON. REV. 1162 (1992) (observing that vote trading is an important determinant of congressional voting behavior).

205. Kuran & Sunstein, *supra* note 132, at 683; *see id.* at 715-27. A legislator may act as an availability entrepreneur and launch availability campaigns through the media and otherwise, all in order to instigate an availability cascade and manipulate the public opinion on the policy issue at hand. *See id.* at 733-36.

206. See Benjamin I. Page & Robert Y. Shapiro, *Effects of Public Opinion on Policy*, 77 AM. POL. SCI. REV. 175 (1983). 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 PUB. OPINION Q. 508, 514 (1990).

207. President Kennedy's actions during the Cuban missile crisis of 1962 demonstrate nuclear brinkmanship. The President increased the risk of an all-out war, thus making compliance with U.S. demands to dismantle the missiles Khrushchev's best response. AVINASH K. DIXIT & BARRY J. NALEBUFF, *THINKING STRATEGICALLY* 205-22 (1991).

208. See DIXIT & SKEATH, *supra* note 150, at 451-59 (conceptualizing brinkmanship). More colloquially, it is the practice of pushing a dangerous situation to the limit in order to force cooperation.

209. Introducing brinkmanship turns the *three-stage game* (shown in Figure 1) into a *multistage game*, in which a firm's failure to comply leads a legislator to take an action in an attempt to increase the probability of threatened legislation. Subsequently, the firm reconsiders whether to comply. If the firm does not comply, the legislator can take another action that further increases the probability, and so on.

firm must know that the legislator has taken these actions. Examples of legislative brinkmanship abound. Negotiating with fellow lawmakers in order to secure sufficient political support is one form of legislative brinkmanship. Pushing 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 possible action.²¹⁰

Its strategic appeal notwithstanding, brinkmanship has one noticeable drawback. While it may eventually induce a firm to comply, brinkmanship also gives the firm an incentive to follow a “wait and see” approach. Mindful of the legislator’s brinkmanship tactics, a firm’s initial best response is “don’t comply.” If, however, by virtue of the legislator’s brinkmanship, the probability of the threatened legislation sufficiently rises, compliance will become the firm’s best response. Viewed from the legislator’s perspective, however, earlier compliance is preferable to delayed compliance. This is because the legislator’s utility depends on the following: (i) if he was successful in inducing a change in conduct; (ii) what the cost incurred in inducing compliance was; and (iii) when that change was achieved. Clearly, the sooner the firm complies and the earlier it modifies its objectionable behavior, the lower is its negative impact on society and social welfare. For this reason, the legislator’s temporal preference is particularly pronounced when she directs a threat towards numerous firms at the same time (e.g., an industrial sector). Yet, as I demonstrate in Part V, strategic delays, free riding, and holdouts are likely to be widespread and delay compliance. Seeking to incentivize early compliance, the legislator may threaten to increase the cost of compliance as time progresses. Specifically, the legislator may threaten that if a firm does not comply early on, he will tighten his demands, thus making later compliance more costly.²¹¹ In summary, the foregoing analysis offers solid theoretical foundation in support of the assertion that “*legislative sagacity reduces itself to a judicious use of strategic behavior.*”²¹²

3. *Extending the analysis to games with perfect and imperfect information*

In some cases a legislator may decide whether to threaten *lenient*, *moderate*, or *severe* legislation. If enacted, the legislation will negatively affect

210. Insofar as taking these actions sinks part of the cost of legislation ex ante, they also reinforce a threat’s credibility. A discussion of the interaction between sunk cost and credibility is found in Part IV.A *infra*.

211. In order to make certain of a 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 engendered by brinkmanship tactics during that same period.

212. This statement is attributed to the Norwegian-American economist and sociologist Thorstein Veblen.

the firm in direct proportion to the leniency, moderation, or severity of its terms. A legislator may also decide whether or not to reveal the level of severity. In order to render the theoretical model most descriptive of the real legislative landscape, this Subpart extends the analysis to consider cases in which a legislator decides: (i) the severity of the threatened legislation; and (ii) whether or not to disclose the chosen level of severity to the firm.²¹³ Incorporating these strategic decisions in the model gives rise to games with *perfect* and *imperfect* information.

Figure 2, which is shown on the next page, represents a game with perfect information. The notion of perfect information captures the fact that both players hold equal amounts of information. Consistent with casual observation, the game is predicated on the assumption that a legislator decides the level of severity and reveals his choice.²¹⁴ The level of severity is therefore a matter of common knowledge in this game. A firm's payoff reflects the cost of compliance²¹⁵ and, if enacted, the negative impact of the threatened legislation.²¹⁶ A legislator's payoff reflects the cost of enacting the threatened legislation²¹⁷ and the benefits received if the legislator is successful in inducing the firm to modify its conduct.²¹⁸

This game is identical to the one discussed earlier (Figure 1), with one exception: here the legislator decides the level of severity of the threatened legislation. Consistent with the earlier analysis, the players' behavior in equilibrium 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. When the threat is incredible, the firm's best

213. Unless provided more information, all the firm knows is that any threatened legislation can be lenient, moderate, or severe.

214. *Cf.* Markoff, *supra* note 69, at C8; Murphy, *supra* note 73 (reporting a legislative proposal that would require disclosure of the company's security status in financial reports filed with the SEC).

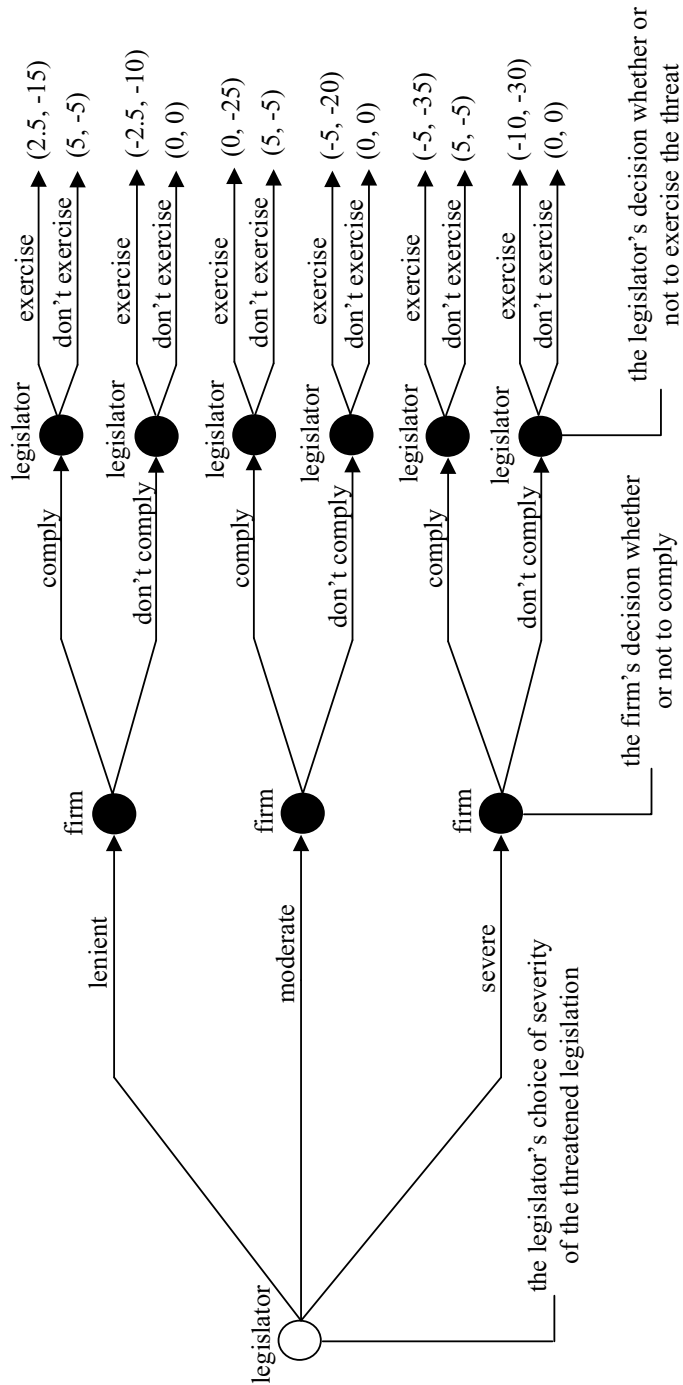
215. The cost of compliance is fixed at 5. A legislator's demands remain unchanged, irrespective of the chosen level of severity of the threatened legislation.

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

217. The cost of enacting the threatened legislation, fixed at 2.5, 5, and 10 respectively, increases with severity. First, a higher level of severity may require more investment of time and resources in research and drafting. Second, with higher severity, opposition in Congress may be stronger, thus requiring more time for securing political support. *Cf.* Thomas J. O'Donnell, *Controlling Legislative Time, in THE HOUSE AT WORK* 127, 138 (Joseph Cooper & G. Calvin Mackenzie eds., 1981) ("[House members'] ability to concentrate time on any single activity is severely constrained by the abundance and complexity of the demands that confront them.").

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

Figure 2. Extensive Form Representation of the Legislative Threat Game with Perfect Information and Three Levels of Severity



response is “don’t comply” and the legislator’s best response is to not carry out the threat. In this *incredible threat equilibrium*, the threat is ineffective in inducing a change in conduct.

Credibility, however, may tilt a firm’s equilibrium behavior towards compliance. When the threat is credible, the firm’s probability assessment becomes a decisive factor in the threat’s capacity to induce a change in conduct. This probability works as a watershed, distinguishing between compliance (i.e., *credible threat compliance equilibrium*) and noncompliance (i.e., *credible threat noncompliance equilibrium*). The key issue, therefore, is whether or not the threatened legislation satisfies the effectiveness condition.²¹⁹ Inasmuch as the cost of compliance remains fixed irrespective of the level of severity, the higher the level of severity, the lower the effectiveness condition becomes, and vice versa.²²⁰ Here, the underlying intuition is as follows: if the threatened legislation harbors harsh terms, it generally makes sense for the firm to comply and avert the legislation’s negative impact even if its probability is rather low. This is so because when firms are perfectly informed, legislators will rationally choose the threatened legislation to be of a high level of severity. By threatening severe legislation, the legislator practically *lowers* the effectiveness condition. This, in turn, provides a clear strategic advantage: the lower the effectiveness condition, the easier the legislator’s task of ensuring satisfaction of the effectiveness condition becomes, and the more likely the firm is to comply.²²¹ *It follows, then, that threatening the firm with harsher legislation guarantees a more potent threat.* Choosing a higher level of severity also increases a legislator’s utility from issuing that threat and effecting change, thus making her better off.

In light of the foregoing predictions, I turn to examine the legislative threat that was directed towards colleges and universities in 2003. In this case, the threatened legislation sought to impose financial penalties on institutions that raised tuition too sharply. Amid the national debate over the threatened legislation, universities and colleges—including Harvard University, George Washington University, and the University of Virginia, among many others—announced voluntary plans to freeze tuition, increase financial aid, and remove

219. This issue concerns the *difference* between the probability of the threatened legislation and the effectiveness condition which, as I have defined earlier, is the lower-bound probability below which a firm will consider compliance inefficient even if the threat is believed to be credible. Hence, a threat’s inducement effect arises provided that that difference is greater than or equal to zero.

220. Recall that, given the probabilistic property of legislative threats, the effectiveness condition is derived from: (i) the cost of compliance; and (ii) the magnitude of the adverse impact of the threatened legislation which, as we know, increases with severity.

221. Note that in order to induce compliance a legislator must ensure that the probability of successfully passing the threatened legislation is greater than (or at least equal to) the effectiveness condition. Meeting this condition becomes easier the lower the threshold condition is.

the burden of loans from some students.²²² Consistent with the present analysis, 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.”²²³ In response, lawmakers announced that they would withdraw the threatened legislation that was “no longer necessary because universities seemed to have gotten the message and were taking steps of their own.”²²⁴

Figure 3, which is shown on the next page, represents a game with imperfect information. The notion of imperfect information captures situations in which one player holds more information than the other.²²⁵ The allocation of information in this game is imperfect because the legislator does not reveal the chosen level of severity, keeping it private. This is consistent with casual observation that shows that rarely do legislators divulge such information. Even more, in some cases a legislator may be—or pretends to be—undecided on this issue at the time she issues the threat.²²⁶ Either way, absent information indicating otherwise, there is an equal chance that the terms of the threatened legislation will be lenient, moderate, or severe.

The dashed elliptic in Figure 3 denotes imperfect information in the following way: while the firm knows that the legislator has *issued a threat*²²⁷ and knows that the threatened legislation may be *lenient*, *moderate*, or *severe*, it does not know (and cannot otherwise observe) what is the level of severity.²²⁸ Hence, the firm does not know which of the three game positions it is at.²²⁹ The firm’s choice of best response strategy—i.e., “comply” or “don’t

222. Winter, *supra* note 197, 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.”).

223. *Id.* (“[The threatened legislation] would have stripped them of their eligibility for millions of dollars in federal grants and programs . . .”).

224. *Id.*

225. Such a game qualifies as one with asymmetric information. See RASMUSEN, *supra* note 158, at 49-50.

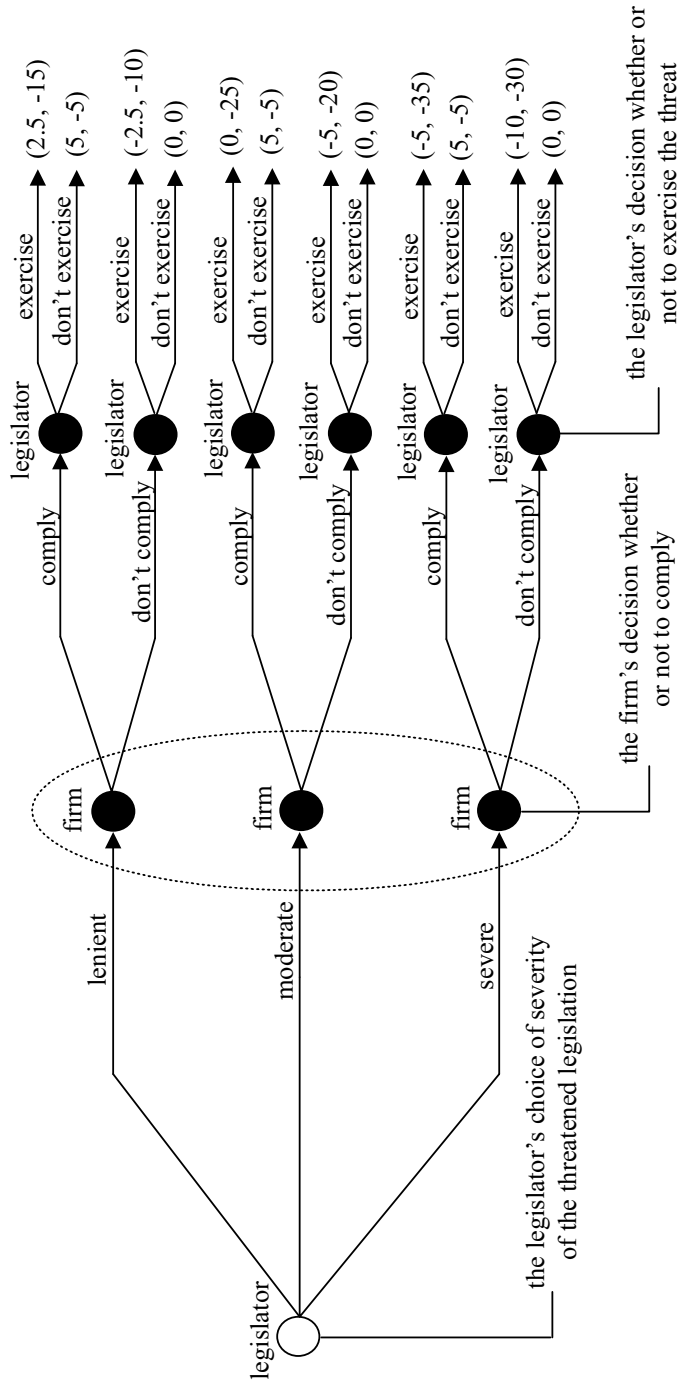
226. Presumably, a legislator may not decide the level of severity in order to reduce the cost of research and drafting as well as the cost of enacting the legislation if she is called upon to carry out the threat.

227. A firm can tell whether a legislator has issued an *explicit* or *implicit* threat. In the case of anticipatory threats, however, a legislator does not issue a threat at all. Here, hard knowledge is replaced with the probability that a legislative threat will be issued in the future.

228. However, a firm may gauge the chance that the threatened legislation is *lenient*, *moderate*, or *severe*.

229. In game-theoretic parlance this is known as an *information set*. A player (here, the firm) is unable to discriminate among positions when choosing an action because he cannot observe the decisions made earlier by the other player (here, the legislator).

Figure 3. Extensive Form Representation of the Legislative Threat Game with Imperfect Information and Three Levels of Severity



comply”—is made in utter ignorance of the level of severity of the threatened legislation it faces.

As in the earlier analysis, the players' behavior in equilibrium depends on: (i) whether the threat is credible; and (ii) whether the probability of passing the threatened legislation is higher or lower than the effectiveness condition. Absent credibility, the firm's best response is “don't comply” and the legislator's best response is to abstain from exercising the threat. These predictions constitute the *incredible threat equilibrium*.

Credibility, however, may change the picture. When the threat is credible, the firm's probability assessment in comparison to the effectiveness condition becomes a decisive factor. In order to choose its best response wisely, the firm must figure out what the effectiveness condition is. But to do so, it must be able to tell the level of severity of the threatened legislation, about which it has no information. Short of this information, the level of severity is mired in uncertainty.²³⁰ 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.

How, then, does imperfect information affect the firm's strategic decision and the threat's inducement effect? Generally, imperfect information may induce the firm to comply in circumstances it would not have complied had it been perfectly informed. Imperfect information is therefore strategically valuable because it can trigger the threat's inducement effect even when the prospects of the threatened legislation in Congress are slim.

To illustrate these points I consider a threat of lenient legislation with respect to which the firm is perfectly informed. For obvious reasons, the effectiveness condition in this case is relatively high. Viewed from the firm's perspective, “comply” is inefficient and irrational *unless* the probability that the threatened legislation passes congressional muster is sufficiently high so as to meet or exceed the effectiveness condition. It follows that if the probability is just a little lower, falling below the effectiveness condition, “don't comply” becomes the firm's best response. Hypothetically, this may be the case when the lenient terms of the threatened legislation draw significant opposition, making its passing improbable.

However, keeping such information private and strategically injecting uncertainty can lead the firm to comply even though, had it known the facts, it would not have complied. As explained, when the firm is imperfectly informed and therefore uncertain of the level of severity (here, lenient), it chooses its best response *as if it faced a threat of moderate legislation*, with respect to which

230. In order to reduce this uncertainty, a firm may assess the likelihood of any particular level of severity. However, this assessment requires information which the firm is presently lacking.

the effectiveness condition is significantly lower (compared with the effectiveness condition for lenient legislation). Driven by uncertainty, and assuming all else remains equal, on average a lower-than-otherwise effectiveness condition renders inducement and compliance more likely.

IV. CREDIBILITY AND THE INDUCEMENT EFFECT OF LEGISLATIVE THREATS

The present theoretical analysis reinforces casual observation that shows that legislative threats can induce sea-change reforms, forcing firms to abandon existing practices in favor of socially desirable ones. This inducement effect depends on the credibility of both the threat to enact the legislation (in case of noncompliance) and the implied promise to refrain from enacting it (in case of compliance).²³¹ Thus, unless both are credible, the threat will have no impact at all.²³² Given the decisive role of credibility, this Part focuses on: (i) the conditions necessary to make the threat (and promise) credible; and (ii) the mechanisms that legislators can avail themselves of in order to ensure credibility.²³³

In general, players' strategic decisions depend on what one player (the firm) believes the other player (the legislator) will do in a particular situation. Given this linkage, strategic behavior involves different actions taken by one player and intended to influence the other player's beliefs and, as a corollary, his strategic choice. Credibility is no exception. The threat maker may take action in order to strategically shape the threat recipient's belief, leading him to believe that the threat maker is credible.

Research in game theory provides insights into the conditions that make such threats and promises credible.²³⁴ Analytically, a threat is considered credible—thus leading the other player to believe the threat maker will carry out the threat—in three cases.²³⁵ First, a threat is credible if accompanied by an

231. It is telling that following the threat to enact legislation to enhance consumer privacy and restrict the flow of personal information, it was reported that “[i]ndustry is certainly doing more than it’s ever done before, but that’s because the threat of legislation is real.” Stacy A. Teicher, *Breaking Ground on Privacy Rights*, CHRISTIAN SCI. MONITOR, Aug. 17, 1999, at 2.

232. Cf. Jose Edgardo Campos & Hadi Salehi Esfahani, *Credible Commitment and Success with Public Enterprise Reform*, 28 WORLD DEV. 221 (2000) (arguing that many public reforms fail because governments have difficulty making credible commitments to sustain the reform).

233. Yet, as explained earlier, credibility is a necessary albeit insufficient condition. In addition, the probability that the threatened legislation will be enacted into law must exceed the effectiveness condition.

234. See generally Daniel B. Klein & Brendan O’Flaherty, *A Game-Theoretic Rendering of Promises and Threats*, 21 J. ECON. BEHAV. & ORG. 295 (1993) (analyzing promises and threats).

235. There is a fourth class of cases, however, in which the threat is credible. In these cases, exercising the threat is rational because it maximizes the threat maker’s utility. But,

action—generally known as a pregame commitment—that, by maximizing the threat maker’s utility from exercising the threat (in response to the threat recipient’s noncompliance), makes it the optimal strategic choice.²³⁶ Second, a threat is credible if the threat maker stakes her reputation on carrying out the threat if called upon to do so.²³⁷ Third, a threat is credible if the threat maker’s decisions are emotional or merely believed to be so, thus driving the threat maker to undertake activities (such as carrying out the threat) beyond the bounds of pragmatic self-interest.²³⁸

It readily follows that unless the threat maker makes a pregame commitment, stakes his reputation on fulfilling the threat, or is believed to be motivated by seemingly irrational emotions, the threat is bound to be incredible and ineffective.²³⁹ In an attempt to gain credibility, legislators may employ various tactics that bind them to carrying out the threat *ex post*, thus making the legislative threat credible *ex ante*. Building on these insights, the discussion that follows below examines how commitments, reputation, and emotions can render threats credible.

because carrying out the threat is *optimal*, issuing the threat does not lock the threat maker into doing something other than what he would have done anyway. In other words, the threat maker will exercise the threat *even if the threat recipient complies*, thus giving him no incentive to comply in the first place. DIXIT & SKEATH, *supra* note 150, at 292, 301. Applied to this context, if a legislator’s payoff from carrying out a threat is *greater* than the payoff received for not doing so, the threat will be *ex ante* credible because it is *ex post* optimal for the legislator to carry it out. Predictably, however, because the legislator exercises the threat *anyway*, the firm has no incentive to comply.

236. There are different ways to ensure that carrying out a threat (or keeping a promise) is optimal. For instance, one may increase his payoff from exercising a threat, making this strategy a utility-maximizing one.

237. KREPS, *supra* note 149, at 65-77 (demonstrating that strategic threats are credible when reputation is at stake).

238. See Jack Hirshleifer, *On the Emotions as Guarantors of Threats and Promises*, in THE LATEST ON THE BEST: ESSAYS ON EVOLUTION AND OPTIMALITY 307, 307-08 (John Dupré ed., 1987) (arguing that emotions that drive people to act beyond their self-interest facilitate credibility and are therefore not necessarily adverse to that person’s self-interest); see also RASMUSEN, *supra* note 158, at 101-02 (enumerating strategically valuable emotional motivations in games, including righteous anger).

239. In a limited set of circumstances, however, a threat may be credible even in the absence of a commitment, reputational motivation, or emotional motivation. See Steven Shavell & Kathryn Spier, *Threats Without Binding Commitment* 3-4 (Nat’l Bureau of Econ. Research, Working Paper No. 5461, 1996), available at <http://www.nber.org/papers/w5461> (arguing that, when exercising a threat is beneficial to the threat maker, a threat becomes credible if it can be repeated an infinite number of times). Moreover, when credibility is mired in uncertainty, the more a firm would suffer from the legislation, the less plausible this strategy of calling the legislator’s bluff is. Cf. David N. Laband, *Stoplight Sales and Sidewalk Solicitations: Some Simple Economics of Forced Consumption*, 7 J. ECON. BEHAV. & ORG. 403, 408-09 (1986) (concluding that threats of extortion by windshield washers at traffic intersections are more credible and therefore more effective when directed towards women, who fear physical harm more).

A. *The Role of Commitments*

An *ex ante* commitment credibly binds a player to carrying out his threat *ex post* because doing so maximizes his utility. In order to effectively bestow credibility, a pregame commitment must satisfy two conditions: (i) it must be irreversible; and (ii) the player must signal the commitment, making it visible and known to the other player (or else the commitment will have no effect on the other player's beliefs or on his equilibrium behavior).²⁴⁰ When both conditions are met, the threat will be afforded credibility. An effective commitment therefore prevents the need to exercise the threat.

The threat maker can ensure that exercising a threat will maximize his utility—and thereby commit himself to carrying out the threat—in three different ways: (i) by lowering the cost of carrying out the threat; (ii) by increasing the benefit from doing so; and (iii) by limiting his *ex post* 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 it *truly* optimal),²⁴¹ the third method eliminates potentially attractive strategies (that is, in the utility sense) from which the threat maker would have been able to choose. Essentially, it leaves him with no other choice but to carry out the threat notwithstanding that, as stated, exercising it is a self-damaging strategy.²⁴² In reality, however, eliminating the other options by no means suggests that the threat maker will *actually* suffer a loss of utility. If the threat is credible (and, expectedly, it will be), the threat recipient will comply with the demands such that the threat maker will not need to exercise the threat.

Using these insights in the analysis of legislative threats helps identify and appreciate tactics that legislators employ in order to credibly commit themselves to carrying out threats.

As stated above, legislators can reduce the cost of carrying out the legislative threat. For instance, they may join cosponsors, enter into political coalitions, or establish alliances with fellow lawmakers. Conceivably, taking these actions can reduce the cost that each legislator incurs in enacting the legislation. Moreover, legislators may opt to sink in advance (that is, prior to making the threat) part of the costs of enacting the legislation.²⁴³ Specifically,

240. See DIXIT & SKEATH, *supra* note 150, at 294-98 (describing conditions in which commitments are effective).

241. Here, rationality—or, more precisely, rational utility maximization—works as a commitment mechanism. Yet, if a legislator were to behave irrationally, higher payoffs would not guarantee that he would exercise the threat.

242. This tactic embraces the counterintuitive 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 with respect to his opponent's future response.

243. Because what matters is what the other player believes his opponent will do, a legislator can *pretend* to have sunk the cost of enacting the adverse legislation and make the

a legislator and her staff can do the preparatory work necessary to enact the threatened legislation, including gathering data, drafting the bill, consulting the Office of Legislative Counsel on drafting matters, negotiating with fellow lawmakers in an attempt to ensure political support, holding committee hearings, and taking other actions that will streamline the legislative process and reduce its remaining costs.²⁴⁴ Having sunk these costs, the cost-benefit analysis of exercising the threat dramatically changes.²⁴⁵ The higher the sunk costs relative to the total costs of enacting the threatened legislation, the more attractive carrying out the threat becomes. Lastly, in order to ensure that these actions gain publicity and forewarn targeted firms of the threat's credibility, legislators may often hand out drafts of the threatened legislation to firms and trade organizations and publicly discuss their effort to further the underlying policy objectives.²⁴⁶

Taking actions that increase the expected benefits from exercising the threat is another way in which legislators may render threats credible *ex ante*.²⁴⁷ Here, the idea is that increasing expected benefits to the point at which they exceed expected costs makes carrying out the threat a utility maximizing choice.²⁴⁸ Insofar as these benefits derive from enhancing a legislator's reputation (e.g., reputation for promoting socially responsible policies),²⁴⁹ then educating the public about the policy in question and building up interest in the

firm believe the cost is by-and-large sunk. Whether or not this strategy is successful depends on whether the legislator can convey this impression credibly and on whether the firm can verify such information.

244. An account of the multistage legislative process is found in Legislative Process: How a Senate Bill Becomes a Law, <http://www.senate.gov/reference/resources/pdf/legprocessflowchart.pdf> (last visited Oct. 6, 2008). See also FARNSWORTH, *supra* note 21, at 65-66 (describing the legislative process in Congress).

245. See RASMUSEN, *supra* note 158, at 98-99 (describing the strategic use of sunk costs). I assume that in addition to *variable costs* that may change from one case to another, introducing and enacting a bill entails some *fixed costs*, including the cost of research, data-gathering, drafting, and negotiating with fellow lawmakers. Incurring these fixed costs in advance, in whole or in part, means that they will not be part of the *ex post* cost-benefit analysis.

246. See, e.g., Markoff, *supra* note 69, at C8 (government officials met with industry representatives to discuss policy concerns and potential legislation).

247. Essentially, these actions are different forms of *specific investment* that a legislator makes in order to make carrying out a threat attractive. Once the investment has been made, the legislator may recoup returns on her investment only by carrying out the threat, thus guaranteeing the threat's credibility. See Tai-Yeong Chung, *On Strategic Commitment: Contracting Versus Investment*, 85 AM. ECON. REV. 437 (1995).

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

249. Cf. JOHN W. KINGDON, CONGRESSMEN'S VOTING DECISIONS 246 (3d ed. 1989) ("Most legislators have their conception of good public policy, and act partly to carry that conception into being.").

particular reform²⁵⁰ will increase the potential reputational rewards from carrying out the threat and therefore amplify the legislator's consequential benefits. These benefits may include higher constituency satisfaction, increased campaign contributions, and—above all—a higher chance of reelection.²⁵¹

Attempting to strategically condition the public's opinion, a legislator may trigger an availability cascade—that is, a process by which an expressed concern initiates a reaction that gives that concern increasing visibility through rising availability in policy discourse.²⁵² Holding committee hearings and using meetings with industry representatives as a means to publicly convey the weighty policy concerns that the threatened legislation is designed to address, a legislator may be able to strategically condition the public's opinion,²⁵³ and increase political support for the threatened legislation.²⁵⁴ In this respect, highly visible hearings may signal the seriousness of the underlying concern and a keen legislative interest in acting on the issue.²⁵⁵ Furthermore, gathering and publicly presenting data that corroborates the socially undesirable consequences of the targeted conduct and establishing substantial interest in reform serves precisely the same purpose.²⁵⁶ In sum, making the effort to

250. Representative 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.” Explaining this, he 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 197, at A14.

251. Cf. Kroszner & Stratmann, *supra* note 166 (noting that “greater reputational development is rewarded with greater political contributions”). Maintaining a “pivotal status” in Senate is associated with a fundraising advantage of \$2.12 million in total election-cycle contributions. See Franklin G. Mixon, Jr., Chena C. Crocker & H. Tyrone Black, *Pivotal Power Brokers: Theory and Evidence on Political Fundraising*, 123 PUB. CHOICE 477 (2005).

252. See Kuran & Sunstein, *supra* note 132, at 715-27.

253. Pregame communications, including congressional committee hearings and meetings with industry leaders and trade organizations, are among the more visible ways in which legislators may “condition” public opinion and interest in the proposed legislative reform. For example, seeking to convey the national concern over cybersecurity, Tom Ridge, then Secretary of the Department of Homeland Security, called a high-profile meeting of 350 computer executives to discuss these issues, share information on the risk of cyberattacks, and learn about the insufficient efforts undertaken, saying “[i]t only takes one vulnerable system to start a chain reaction that can lead to devastating results.” See Markoff, *supra* note 69, at C8.

254. Cf. Page & Shapiro, *supra* note 206 (showing that Congress acts in response to changes in public opinion almost two-thirds of the time).

255. Following hearings before the Senate Commerce Committee on the use of steroids in professional sports, Senator McCain explained that holding these high-profile hearings had been an attempt to pressure the baseball league to act. See Puzanghera, *supra* note 112, at 1A.

256. As is customary on Capitol Hill, introducing a bill is accompanied by elaborate publicity. See Redman, *supra* note 63, at 93-97 (describing legislative public relations, speeches, and media coverage).

maintain a tough stance on policy issues and demonstrating a benevolent and proactive approach to social affairs may render the threats credible and ultimately pay off.

Lastly, a legislator may also commit to exercising a threat by “tying her hands” in advance—essentially, by eliminating *ex ante* any *ex post* option other than carrying out the threat. The firm must be made aware of this “hands tying” if the threat is to become credible. For instance, delegating the power to exercise the threat to an agency serves this strategic purpose.²⁵⁷ In order to guarantee that a threat will be carried out if need be, the legislator may delegate the power to a reputable agency known for its subservient performance,²⁵⁸ or, alternatively, to an agency known to be captured by special interest groups that are keen on promoting the policy that underlies the threatened legislation.²⁵⁹ Delegation does not guarantee complete credibility, however. For, at least in theory, statutory delegation can be revoked, though not without effort and time investment, a fact that mitigates this problem and reduces its likelihood.

B. *The Role of Reputation*

Staking one’s reputation for honesty, integrity, toughness, benevolence, or simply for keeping one’s word on carrying out a threat, if and when predetermined triggering conditions are met, will render the threat credible. Here, the intuition is the following: given a threat maker’s reputation, it is in her best interest—and, therefore, her best response—to avoid doing anything in the game that adversely affects her reputation and reduces her long-term utility.²⁶⁰ Failing to carry out a threat in the face of noncompliance surely damages one’s reputation and reduces expected payoffs from future games.

257. See DIXIT & SKEATH, *supra* note 150, 301, 308-09 (discussing the strategic role of delegation in reducing a player’s *ex post* freedom of choice and in facilitating credibility).

258. See Sebastian Krapohl, *Credible Commitment in Non-independent Regulatory Agencies: A Comparative Analysis of the European Agencies for Pharmaceuticals and Foodstuffs*, 10 EUR. L.J. 518 (2004) (noting that the agency’s institutional structure is a determinant of credible delegation).

259. See DIXIT & SKEATH, *supra* note 150, at 301-02 (delegating the power to exercise the threat to an agency captured by special interest is strategically valuable). This delegation may be problematic because it may create the risk that the agency will exercise a threat even when threat recipients comply, thus stultifying the threat’s purpose. Cf. Ernesto Dal Bó & Rafael Di Tella, *Capture by Threat*, 111 J. POL. ECON. 1123 (2003) (noting that when policy makers are threatened by “nasty” interest groups, good policies are less likely to be implemented). Hence, while such delegation facilitates a threat’s credibility, it may undermine the credibility of the related promise to refrain from enacting the threatened legislation if the firm complies, ultimately diminishing the firm’s *ex ante* incentives to comply.

260. Clearly, it makes sense to forgo a small cost saving (that is, to incur extra cost) in a particular game in order to avoid negative repercussions in future games which, by definition, are greater. For an informal explanation of the strategic value of reputation and its effect on behavior see KREPS, *supra* note 149, at 65-72.

This is so because a threat maker's reputation essentially creates a *linkage* between the acts she takes in the present game and the payoffs she may expect in future games (which, too, depend on her reputation).²⁶¹ Under these conditions, a threat is credible given that a threat maker stakes her reputation on carrying out the threat, and 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 if called upon to do so. Logically, this reputation also ensures the credibility of the related promise.

In the course of her political tenure, a legislator may develop and maintain a solid reputation for promoting consistent policies; for taking a tough stance on defined policy issues, including the one presently in question; for advancing specific causes; and for being of high integrity, namely by keeping her word and promises. A legislator's good reputation credibly commits her to exercising the threatened legislation if the firm does not comply and, conversely, to foregoing enactment if her demands are duly met.²⁶² Offering a similar observation, Gordon Tullock has insightfully noted, albeit in a different context, that "politicians may sometimes have to enact legislation . . . just as the *Cosa Nostra* occasionally burns down the buildings of those who fail to pay its protection levies."²⁶³ Mindful of a legislator's reputation, a firm is led to believe that a legislative threat is credible. Ultimately, a firm will comply with a legislator's demands because, given the threat's credibility, compliance will maximize its utility and thus becomes the rational and prudent strategic choice.²⁶⁴

261. For this reason, the payoffs from future games are contingent upon behavior in earlier games. Hence, when considering any one of these games, a threat maker should adjust her expected payoffs to account for potential repercussions for damaged reputation.

262. While the discussion focuses on a legislator's reputation (good or bad) for carrying out threats, it does not consider a firm's or an industry's reputation (good or bad) for complying with legislative threats. See RASMUSEN, *supra* note 158, at 117-18 (discussing reputation as a two-sided dilemma). Developing a reputation is not implausible because, as repeat players, firms are frequently subject to threats of legislation. A good reputation becomes valuable because it reduces the cost of bargaining and enables the legislator and firms to devise a desirable solution. Cf. JACKSON, *supra* note 131, at 1 (noting that a firm's reputation is essentially a form of capital). Moreover, it is inconsequential whether repeated threats (targeting different behaviors) are made by the same legislator or by others because the behavior of firms in these games and hence their reputation (or lack thereof) can be observed by all legislators (theoretically, even in future congresses).

263. GORDON TULLOCK, RENT SEEKING 74 (1993).

264. Legislative threats remain credible as long as a legislator has a reputation to protect and as long as maintaining that reputation is efficient—namely, insofar as future benefits from that reputation exceed the short-term cost of maintaining it (i.e., the cost of enacting the threatened legislation in the present game). If, however, there are no more opportunities to use that reputation—as where the legislator's term in office ends—a threat will turn incredible. Mindful of the game's last round, a firm will have no incentive to comply. See KREPS, *supra* note 149, at 70.

It follows that investing in reputation development and solidifying that reputation makes the legislator better off.²⁶⁵ First, maintaining a good reputation is worth more than any short-term benefits that a legislator may obtain by sullyng her reputation. For example, the credibility assurance of a good reputation enables a legislator to promote public policies without enacting the desired policy into law and without incurring the significant cost of doing so.²⁶⁶ A good reputation is therefore crucial for securing threat-induced compliance. It guarantees the threat's inducement effect, thereby making the threatened legislation unnecessary, saving costs, and increasing a legislator's utility.

Second, given that a legislator's reputation is ordinarily 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 a legislator's threats, and conduct themselves accordingly, ultimately reinforcing a legislator's political status and enhancing her political capital.²⁶⁷

Third, working to advance a policy agenda and maintain a good reputation is in a legislator's best interest inasmuch as failure to do so carries an electoral price. Confirming this point, empirical research shows that legislators' campaign contributions are positively correlated with their reputation.²⁶⁸ This is partly why legislators with better reputations are more politically successful and more likely to win reelection than legislators who have no reputation at all (e.g., junior legislators with a short track record) or those who are known to have a bad reputation.

A good reputation evolves over time as firms, organizations, and other threat recipients observe how a legislator has acted in previous strategic interactions and learn of a legislator's reputation. The more intensive the interaction between the legislator and targeted entities (i.e., currently or

265. In the present game, a legislator's investment (in utility terms) in reputation development is equal to the cost (i.e., the negative payoff) of exercising the threat if predetermined triggering conditions arise. As shown in Figure 2, the loss from enacting lenient, moderate, and severe legislation is 2.5, 5, and 10, respectively.

266. Considering the payoffs shown in Figure 2, enacting the threatened legislation is costly to the legislator. For example, the payoff for enacting lenient threatened legislation is -2.5. If the firm complies, the legislator benefits from achieving the desired policy reform while doing nothing, in which case the payoff is 5. Hence, having no reputation of any kind or having a bad reputation entails a loss of 7.5.

267. The repeated nature of the game ensures that any reputation will be widely known. See DIXIT & SKEATH, *supra* note 150, at 310-11 (noting that reputation is valuable when future players can observe actions a threat maker has previously taken in games played with others).

268. See Kroszner & Stratmann, *supra* note 166, at 41 (noting that "greater reputational development is rewarded with greater [political] contributions"). A legislator's reputation also guarantees cooperation between a legislator and his constituents. See Kroszner & Stratmann, *supra* note 128.

potentially targeted) is, the farther away the time horizon, the more likely the legislator is to acquire a good reputation. In this respect, research shows that members of congressional standing committees avail themselves of repeated interaction with firms, thus fostering reputation building.²⁶⁹

C. *The Role of Emotions*

Intuition and casual observation suggest that emotions may wield a formidable impact on behavior, compelling individuals to take actions that at first glance may seem inconsistent with their utility maximizing self-interest.²⁷⁰ Confirming this crude intuition, social psychologists demonstrate the power of consistency and other emotional motivations in directing human behavior. Experiments show, for example, that individuals are predisposed to behaving in ways that are consistent with their earlier statements and positions.²⁷¹ It follows that a verbal or unspoken commitment—this time, however, in its ordinary literal sense—has the capacity to constrain behavior.

Formalizing these insights into refined economic models, economists Jack Hirshleifer²⁷² and Robert Frank²⁷³ explain how certain emotions, passions, and moral sentiments—including righteous anger, vengeance and meanness, equality and accountability, vanity, the desire to satisfy public outrage,²⁷⁴ altruism and public spirit,²⁷⁵ decency, and the care for fairness²⁷⁶—commit

269. Reputation-building is necessary to maximizing contributions. See Kroszner & Stratmann, *supra* note 129 (empirically supporting this argument).

270. Bringing a legal action against a transgressor, despite the near-zero probability of winning the case, is a common example of an emotionally motivated behavior. Actions of revenge, common in some communities or where the rule of law is ineffective, provide additional examples. Refraining from cheating, even when one knows he cannot be caught or punished, demonstrates the same point.

271. See ROBERT B. CIALDINI, *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.”).

272. See Hirshleifer, *supra* note 238, at 307-09 (noting that emotions that drive people “to act beyond the bounds of pragmatic self-interest” facilitate credibility and are not necessarily adverse to that person’s self-interest); RASMUSEN, *supra* note 158, at 101-02 (enumerating emotional motivations).

273. See generally ROBERT H. FRANK, *PASSIONS WITHIN REASON* (1988).

274. The Rodney King trials in the early 1990s demonstrate the effect of emotional motivations. See RASMUSEN, *supra* note 158, at 101 (“[R]egardless of the merits of the cases against the policemen who beat Rodney King, the prosecutors wanted to go to trial to satisfy the public outrage.”).

275. See Thomas C. Schelling, *Altruism, Meanness, and Other Potentially Strategic Behaviors*, 68 AM. ECON. REV. 229 (1978) (noting that altruism and meanness are strategically valuable insofar as they influence others by affecting their expectations of what the altruist or mean individual will do).

276. The concern for fairness encompasses different preferences and notions of

individuals to undertaking activities beyond the bounds of pragmatic self-interest.²⁷⁷ Paradoxically, while emotion-driven behaviors appear to be in conflict with one's self-interest (and, hence, irrational), they *actually promote* self-interest.²⁷⁸ Seemingly irrational emotional motivations serve one's narrow self-interest because they act as commitment devices that bind a person to behaving in a particularly predicted way that is in line with emotion, passion, or preference.²⁷⁹

Undoubtedly, emotions and other motivating sentiments are not estranged from the legislation and policy arena. In fact, confirming this observation, Nobel laureate economist James Mirrlees cautioned that "government ministers [ought] to try to maximize utility, even if their personal sense of achievement is gravely compromised, their crazy industrial dreams unfulfilled."²⁸⁰ Hence, if threat recipients *believe* that the threat maker is motivated by a specific emotion or preference (say, righteousness or accountability), they will be led to conclude that that person will carry out the threat *even if* the cost of doing so is prohibitive. In fact, given this emotional motivation or preference, the ensuing emotional sense of fulfillment makes a legislator's benefits from exercising the threat far greater than those that would have otherwise accrued.²⁸¹ It is therefore precisely this sort of *belief*—that a threat will be carried out even if it is not in the threat maker's material interest to do so—that makes a threat credible. Taking the effect of emotions into account, threat recipients will have strong incentives to comply with the threat maker's demands.

In fact, legislative threats may turn credible if—based on public information, existing track record, or due to a legislator's attempt to strategically change his mind²⁸²—targeted firms believe, *correctly* or *erroneously*, that a legislator is driven by emotions (or motivations) that will be

fairness, including that of keeping one's promises. See LOUIS KAPLOW & STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* 38-45 (2002).

277. The effects of passions and emotions on human behavior and social interaction have occupied social theorists and moral philosophers. See *generally* ALBERT O. HIRSCHMAN, *THE PASSIONS AND THE INTERESTS* (1977) (noting that capitalism was originally supposed to accomplish exactly what was soon denounced as its worst feature, namely the repression of passions in favor of "harmless," if one-dimensional, self-interest). 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 R.H. Coase, *Adam Smith's View of Man*, 19 J.L. & ECON. 529, 542-43 (1976).

278. See Hirshleifer, *supra* note 238, at 308 ("A person can sometimes best further his self-interest by *not* intending to pursue it.").

279. See FRANK, *supra* note 273, at 4-7.

280. J.A. Mirrlees, *The Economic Uses of Utilitarianism*, in *UTILITARIANISM AND BEYOND* 63, 71 n.13 (Amartya Sen & Bernard Williams eds., 1982).

281. Cf. DIXIT & SKEATH, *supra* note 150, at 312 ("Apparent irrationality can then turn into strategic rationality when the credibility of a threat is in question.").

282. For an insightful discussion of how politicians change the minds of others see HOWARD GARDNER, *CHANGING MINDS* 69-89 (2004).

triggered by a firm's failure to comply with the legislator's demands. Such emotions and motivations may guarantee the credibility of a threat, provided that threat recipients *actually believe* the legislator cares about these preferences or is generally motivated by these emotions. Mindful of the threat's credibility, firms will realize that if they do not comply the legislator will seek to enact the threatened legislation, notwithstanding its significant costs. Belief in a threat's credibility thus sets in motion the inducement effect of a legislative threat.

V. THE EFFECTS OF STRATEGIC INTERACTION WITHIN GROUPS ON THREAT-INDUCED COMPLIANCE

Legislative threats exerted on a single firm are rather an exception, certainly not a commonplace scenario. 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., exchange-listed 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). I refer to any such pool as a *group of threat recipients*.

While some groups are homogenous, others are heterogeneous because firms in those groups may differ in size, market share, investment horizon, and like considerations. Moreover, while some groups are organized in trade associations, industrial alliances, or labor unions, others might not be, acting therefore in an uncoordinated fashion. Lastly, groups may also vary in size, ranging from a mere few, as in an oligopoly, to several hundreds and beyond, as in established professions.

A legislative threat directed towards a group normally requires that *all* of its members²⁸³ comply with the stated demands.²⁸⁴ Accordingly, anything

283. In order to make this threat operative, the legislator must be able—by himself or through an agent—to tell whether group members have complied. *See, e.g.,* Jameson, *supra* note 110 (noting that a working group reported to the Planning Minister the inability of group participants to reach an agreement; the minister responded with a threat to introduce legislation).

284. In theory, a legislator may demand compliance by a predetermined share of the group (e.g., two-thirds of group members). In order to make this threat operative, the legislator must be able to tell compliant firms from noncompliant firms, so as to determine whether the demands for compliance have been met. Yet, because compliance by a predetermined share of the group will avert the risk of legislation facing the group as a whole (which will benefit all the members of the group), compliance essentially becomes a public good. This is why, absent effective in-group enforcement mechanisms, widespread free-riding is likely to defeat compliance altogether and make the group and the legislator worse off. *Cf. Matthias Cinyabuguma, Talbot Page & Louis Putterman, Cooperation Under the Threat of Expulsion in a Public Goods Experiment*, 89 J. PUB. ECON. 1421 (2005) (finding

short of group-wide compliance will lead a legislator to carry out a threat.²⁸⁵ This immediately raises the following question: are group members likely to comply with a legislator's demands so as to avert the threat of legislation? Focusing on this question, this Part examines the effects of strategic interaction within groups—whether organized or unorganized, homogeneous or heterogeneous, small or large—on the prospects of threat-induced, group-wide compliance. In so doing, the analysis considers the model's predictions as they apply to groups.

As explained earlier, a player's best response strategy crucially depends on what that player believes the other player will do in a particular situation. Applying this insight to the group context, the best response strategy of any single firm depends on what that firm believes the legislator will do in response to strategies played by other firms in the group. The firm's belief regarding what the legislator will do therefore depends on what that firm believes is the best response of other firms in the group to what the legislator will do, and so on. Viewed from a single firm's perspective, deciding which strategy is the firm's best response becomes a *two-dimensional strategic decision*. First, it depends on what the firm believes the legislator will do in response to strategies played by other firms in the group. Second, it depends on what the firm thinks the other firms believe the legislator will do in the particular situation and then, on what they will do in response. Hence, a firm's decision to comply or not comply is driven in part by the decisions (whether to comply) made by other firms in the group. Each firm therefore plays two games: one with the legislator and the other with its group cohorts.

In light of the foregoing, I turn to examine the effects on compliance of strategic interaction within homogenous and heterogeneous groups.

A. Homogeneous Groups

Homogenous groups include firms whose interests, insofar as they affect their incentives in the game, are identical.²⁸⁶ Firms' interests are said to be identical when their expected payoff in the game is the same. Specifically, when firms are similarly situated—including, for example, when market power

that member participation increases significantly when threatened by expulsion or ostracism).

285. Imposing a strict condition of group-wide compliance makes good game-theoretic sense. If the legislator has ex post discretion to take account of how many firms complied before deciding 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 firms may use, such as partial compliance, to "whittle down" the threat. See DIXIT & SKEATH, *supra* note 150, at 315.

286. The fact that group members, like firms in an industry, may compete against each other on business and market share does not negate the fact that their incentives, as they relate to the game, are identical.

is equally distributed, when firms are of similar size, when firms have similar manufacturing capacity, or when firms are equally competitive—no payoff variability exists. It follows that if compliance qualifies as the *firm's* best response strategy, it logically also constitutes the best response strategy of the *group* as a whole. When interests are identical, avoiding unfavorable legislation is equally beneficial to every member in the group.

Even though compliance is in every member's best interest, group-wide compliance—which, as stated, is necessary to avert the risk of adverse legislation—crucially depends on group size. In sufficiently small groups, such as close-knit oligopolies, members may contract with one another—explicitly or tacitly—so as to ensure that each member complies and that the group as a whole wards off the risk of legislation.²⁸⁷ Intragroup threats of ostracism or cross-punishments guarantee that members will abide by their agreements. Moreover, given a group's small size it is reasonable to assume that a legislator would be able to tell whether members have duly complied, which would further reinforce members' incentives to secure group-wide compliance.

As groups grow in size, however, contracting becomes costly and manifestly impractical.²⁸⁸ Furthermore, collective action problems that inhere in group behavior militate against voluntary group-wide compliance, even though compliance—to the utter exclusion of any other strategy—is guaranteed to maximize members' utility.²⁸⁹ Group organization thus becomes a decisive factor. By employing rules and invoking social norms, a governing body can impose sanctions,²⁹⁰ enforce certain actions, and reduce holdouts—all of which are necessary in order to secure group-wide compliance in order to keep the risk of legislation at bay.²⁹¹ A group's governing body also engages a legislator in regulatory bargaining (in lieu of strict compliance) on behalf of the group.

287. See KREPS, *supra* note 149, at 74 (“This is . . . the common-sense notion of a cartel. Each firm abides by the discipline of the cartel because each does better than if cut-throat competition ensues.”). While cartel members are confined to implicit contracting (i.e., tacit collusion) due to the illegality of cartel agreements, group members seeking to ward off legislative threats may enter into explicit agreements.

288. See AVINASH K. DIXIT, *LAWLESSNESS AND ECONOMICS* 59-67 (2004).

289. *Cf.* MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION 2* (1971) (noting that, given collective action problems, public goods are not produced at the desirable level for the group as a whole).

290. See Laurence R. Iannaccone, *Sacrifice and Stigma: Reducing Free-Riding in Cults, Communes, and Other Collectives*, 100 J. POL. ECON. 271 (1992) (finding that efficient groups may use stigma to reduce free-riding); 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) (finding that groups employ sanctions to enforce discipline on group members).

291. Organized groups may also establish a monitoring system that keeps track of members' compliance. See, e.g., BRITISH PROP. FED'N, *supra* note 111 (noting that the British Property Federation was appointed to monitor implementation on behalf of the property sector).

In a limited set of circumstances, however, group-wide compliance may ensue even though a group is unorganized. When noncompliance is likely to damage members' reputations (e.g., for being good corporate citizens), and when members value their reputation,²⁹² incentives to comply may arise even in the absence of centralized intragroup enforcement. Specifically, in an attempt to protect their reputational capital from being damaged by other members' noncompliance—which constitutes a negative externality—individual members may impose sanctions on each other, ultimately triggering a *reputational cascade*.²⁹³

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. Threat-driven efforts to organize have been observed in many cases. Facing a threat to legislate stringent recycling requirements and “scrambling to come up with a system that is voluntary but still effective,” PC companies joined forces to form the National Electronics Product Stewardship Initiative, a working group designed to develop proper solutions.²⁹⁴ Similarly, responding to the government's threat to legislate cybersecurity 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,²⁹⁵ was the first step towards averting the risk of legislation.²⁹⁶

Given the decisive role of organizations in ensuring group-wide compliance (and, as explained in Part VI, in facilitating effective regulatory bargaining), legislators often encourage—both in word and in deed—the process of organizing. Legislators may do so on an ad hoc basis by convening targeted firms, thus reducing the transaction costs of organizing.²⁹⁷ They may also provide statutory funding for group participation in congressional committee or agency hearings, thus subsidizing the cost of organizing otherwise unorganized groups.²⁹⁸ Lifting the cost of organizing makes good

292. See JACKSON, *supra* note 131 (describing how reputation for responsibility and other virtues is a form of capital).

293. Cf. Kuran Timur, *Ethnic Norms and Their Transformation Through Reputational Cascades*, 27 J. LEGAL STUD. 623 (1998) (describing how reputational cascades may unite group members behind one position).

294. Harrison, *supra* note 101, at 1D.

295. Cf. Murphy, *supra* note 73.

296. *Id.* (describing how the Alliance coordinated private sector self-regulation with government policy aims).

297. Having threatened legislation to impose cybersecurity standards, lawmakers convened 350 computer executives at the government-sponsored National Cyber Security Summit. See Markoff, *supra* note 69, at C8. In response, the industry formed the National Cyber Security Summit Alliance.

298. See, e.g., Consumer Product Safety Act, 15 U.S.C. § 2056(c) (2006); Magnuson-Moss Warranty-Federal Trade Commission Improvement Act, Pub. L. No. 93-637, § 202, 88 Stat. 2183 (1975) (repealed 1994).

strategic sense. Organizations may secure group-wide compliance and reduce the cost of regulatory bargaining, consequently increasing the legislator's payoff from using the legislative threat to regulate conduct and ultimately boosting her reputation and utility.

Group organization increases the likelihood of group-wide compliance and renders legislative threats more effective as catalysts of reform. Moreover, the tendency towards organization reduces the transaction costs of regulatory bargaining, consequently enabling legislators and groups to share information, negotiate, and design superior regulatory measures. The latter effect further reinforces a legislator's incentive to use threats and a group's impetus to organize. The growing use of legislative threats and the increased probability of recurring threats suggest that groups repeatedly targeted by threats will be better off investing in the one-time cost of organization early on.²⁹⁹ Lastly, insofar as legislative threats increase a group's propensity to organize, the widespread use of threats may counter social and economic processes that contribute to the gradual weakening and steady disintegration of organizations.³⁰⁰

B. *Heterogeneous Groups*

Groups are considered heterogeneous if a legislative threat affects their members in different ways. Such payoff variability may be driven by a variety of factors. For example, smaller firms in the industry may suffer more onerous consequences than larger firms. If compliance requires a fixed investment (e.g., installing a new technology), smaller firms—which benefit from lower economies of scale and incur higher costs of capital—may find this expenditure economically infeasible.³⁰¹ For this reason, compliance may force relatively small firms out of the market. In other cases, however, smaller firms may be better positioned to comply. This is likely to be the case when switching costs (i.e., the cost of switching from one regulatory regime to another) increase with firm size.

Payoff differences may also be related to a firm's position in the market. When a threat aims to eliminate barriers to entry and make a market more

299. The costs of organization are akin to start-up costs: "Once they are borne, they do not affect marginal costs Groups that have already borne these start-up costs . . . will have a comparative advantage" in securing compliance, in fending off the risk of legislation, and in shaping the regulatory environment in which they operate. ROBERT E. MCCORMICK & ROBERT D. TOLLISON, *POLITICIANS, LEGISLATION, AND THE ECONOMY: AN INQUIRY INTO THE INTEREST-GROUP THEORY OF GOVERNMENT* 17 (1981).

300. See, e.g., RICHARD A. EPSTEIN, *SIMPLE RULES FOR A COMPLEX WORLD* 167-69 (1995) (identifying market forces responsible for the gradual decline of labor unions).

301. Recall that the model assumes that the costs of compliance are fixed. Their magnitude does not change across firms; installing technology costs the same irrespective of firm-specific characteristics.

competitive, a dominant firm that enjoys quasi-monopolistic rents will suffer harsher consequences than will a laggard operating on the fringe of the market.³⁰² Difference in legal status may also produce payoff disparities, as when a threatened legislation ends the valuable SRO status that several firms in the group may presently enjoy.³⁰³ Different risk preferences and risk-bearing capabilities may similarly produce payoff variations. Lastly, differences in entities' investment horizons may also affect their perception of the game's payoffs.

These points lead to the following question: are group members likely to comply so as to avert the threat of legislation—and if so, under what conditions?

Unless group-wide compliance is obtained, a legislator will exercise the threat. Considering this, individual group members may strategically comply or not comply in order to shape the regulatory environment in which they—as well as their current and potential rivals—do business. In particular, they may strategically comply or not comply so as to impose costs on rivals, reduce their profits, or otherwise improve their own position in the market. Ultimately, whether group members comply depends on: (i) the number of members in the group; (ii) the distribution of economic power within the group; and (iii) the availability of intragroup enforcement mechanisms, the use of which is also affected by the distribution of economic power.

When groups are relatively small, members may contract with one another and ensure compliance. In contrast, larger groups—for which contracting is not a viable option—may resort to enforcement mechanisms (similar to those discussed above) in an attempt to guarantee compliance and ensure that the risk of legislation is dissuaded. Absent effective enforcement, however, compliance and noncompliance are used strategically, thereby providing a tool to promote members' idiosyncratic interests. Hence, while in some circumstances intragroup strategic interaction may undermine compliance, in certain other cases it may counterintuitively reinforce it.

An incumbent firm may engage in *predatory compliance*. For example, the incumbent may comply with demands a legislator imposes to increase competition in the market in order to lower market prices and drive its rivals out of the market.³⁰⁴ Likewise, a dominant firm may engage in *predatory noncompliance* in order to trigger the adverse legislation and raise rivals' costs, ultimately aiming to crowd them out of the market and snatch their market

302. Cf. McDowall, *supra* note 143 (describing how the “threat of legislation may be required to elicit changes” that enhance competition in U.K. payment systems).

303. See, e.g., Prynne, *supra* note 172 (reporting a legislative threat that might, with respect to Lloyd's, “end its jealously guarded self-regulatory status”).

304. See McDowall, *supra* note 143 (describing how a legislative threat could enhance competition in payment systems).

share.³⁰⁵ Predatory noncompliance may also serve to deter the entry of potential rivals.³⁰⁶ Rationally, an incumbent may be willing to sustain the unfavorable impact of a threatened legislation, the costs of which will be 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 content producers needed to agree on a standard to stop digital piracy³⁰⁷—one sector strategically may not cooperate, all in an effort to increase the other sector’s potential loss and improve its own bargaining position.³⁰⁸

VI. BARGAINING IN THE SHADOW OF LEGISLATIVE THREATS

In essence, complying with a legislator’s demands is an implicit and informal political transaction in which the legislator barter the non-use of legislative power with respect to a particular issue in return for the firms’ commitment to change their conduct. Reinforcing this observation, game theorist Thomas Schelling noted that “[t]o study the strategy of conflict is to take the view that most conflict situations are essentially *bargaining* situations.”³⁰⁹ Yet, compliance with a legislator’s demands is often replaced by explicit and formal bargaining in the shadow of legislative threats. Legislators and firms convene, exchange information, negotiate, and tailor measures to address the concerns that prompted the legislator to issue the threat in the first place.³¹⁰

305. See DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 353-57 (3d ed. 2000).

306. Research confirms that established firms can affect the difficulties facing potential entrants, the magnitude of entry costs, and the existence of entry barriers. See generally Kofi O. Nti & Martin Shubik, *Noncooperative Oligopoly with Entry*, 24 J. ECON. THEORY 187 (1981) (providing a mathematical model for how firms’ strategic behavior can erect barriers to entry).

307. See *Bill Would Prevent Sharing of Digital Music, Video*, *supra* note 84; see also Brooks Boliek, *Lawmakers Push Fast-Forward to Settle DVD Dispute*, HOLLYWOOD REP., May 20, 2004 (describing how compliance required cooperation between the Directors Guild of America and a DVD manufacturer).

308. See, e.g., Jameson, *supra* note 110 (“The deadlock is being blamed on some of the UK’s major retailers . . . It’s clear that they would like to see intervention” (internal quotation marks omitted)).

309. THOMAS C. SCHELLING, *THE STRATEGY OF CONFLICT* 5 (1960) (describing how “bargaining . . . may involve threats of damage”); see also JOHN F. NASH, JR., *The Bargaining Problem*, in *ESSAYS ON GAME THEORY* 1, 1-8 (1996) (describing how bargaining can “be regarded as a nonzero-sum two-person game.”).

310. See, e.g., Dave Sheinin, *Pro Sports Leagues Pitch Steroids Proposals on Hill; Plans Touted as Better than Fed Policy*, WASH. POST, May 19, 2005, at D1 (“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 . . . and made their

The analysis in this Part reveals two important and interrelated effects of using legislative threats as a regulatory mechanism. First, the use of threats reduces transaction costs and facilitates regulatory bargaining. Second, the use of legislative threats and the onset of regulatory bargaining may result in superior regulatory measures, capable of dealing with the underlying policy concerns in a functionally effective and welfare-enhancing manner. The discussion that follows develops these insights more fully.

As the earlier analysis demonstrated, when the probability of a threatened legislation being enacted into law is sufficiently high, credible threats will induce compliance with the demands that the legislator has presented.³¹¹ Facing the consequences of coercive legislative intervention, compliance inexorably becomes a firm's best response.³¹² However, that said, compliance will remain the best response *only* insofar as there is no other way in which a firm can respond to the legislator's demand for reform and address its underlying policy concern more efficiently.

Superior options certainly exist, however. Bargaining with legislators or other social planners enables firms to explore, design, and negotiate cost-effective, self-regulatory measures. Compared with the fixed cost of compliance with a legislator's superimposed demands for reform, any negotiated measure that reduces this cost or secures additional benefits for firms—beyond the benefit of averting the threatened legislation³¹³—makes bargaining the best response strategy.

A credible threat shapes the relative bargaining power of the parties, leaving it in the hands of the legislator.³¹⁴ Given the impending threat on the one hand and the expected efficiency gains from bargaining on the other, firms are strongly incentivized to pursue the bargaining option. They are equally motivated to share sufficient information with the legislator, which is necessary in eliminating information asymmetries, devising mutually beneficial measures, and entering into an agreement. Hence, legislative threats function as an

cases for why each sport's self-policing remains a superior alternative to a decidedly tougher, federally enacted policy.”).

311. This statement relies on the predictions of the credible threat compliance equilibrium.

312. The magnitude of these costs increases with the severity of the threatened legislation. As shown in Figure 2, the negative impact of lenient, moderate, and severe legislation is 10, 20, and 30, respectively.

313. Averting the risk of legislation is desirable because, in addition to the superior cost-effectiveness of self-regulation, it reduces uncertainty about the firm's future, which is normally associated with lower returns, increased volatility, and higher capital costs. *Cf.* Beck et al., *supra* note 136 (arguing that firms suffered negative stock returns following announcement of potential adverse legislation); Ferguson & Witte, *supra* note 170 (showing that stock returns are lower and price volatility is higher when Congress is in session).

314. *See generally* Russell Korobkin, *Bargaining Power as Threat of Impasse*, 87 MARQ. L. REV. 867 (2004) (arguing that “relative bargaining power stems entirely from the negotiator's ability to . . . credibly” threaten to reject unsatisfactory offers).

information-revelation mechanism, mitigating the legislator's inability to obtain pertinent information directly.³¹⁵

Moreover, because exercising a threat provides a legislator with a credible fallback option, the transaction costs of bargaining are likely to be kept to a bare minimum. Reducing the magnitude of transaction costs—including the cost of exchanging information, forecasting scenarios, negotiating, and designing measures—decreases the degree of *contractual incompleteness*³¹⁶ and facilitates efficient bargaining.³¹⁷ When transaction costs are low, the parties are better positioned to: “First, *think* very far ahead and . . . plan for . . . various contingencies Second, . . . *negotiate* about these plans” and devise proper measures; and third, write the contract in clear, unambiguous language that leaves little room for vagueness and uncertainty.³¹⁸ Specifically, the parties may negotiate flexible, long-term social control arrangements, thus increasing the durability of such agreements and eliminating much of the deadweight transaction costs of dickering in the future.³¹⁹ Lowering contractual incompleteness also decreases the likelihood of future revisions and renegotiations, ultimately reducing the level of uncertainty. When uncertainty about the future is lower, firms are better positioned to make long-term investments necessary to produce change. Lastly, drafting firms' contractual obligations in clear and unambiguous language makes it easier for a legislator to monitor firms' performance, to ensure that they abide by their contractual obligations,³²⁰ and to deter possible breaches, the result of which would be reinstatement of the threat of legislation.³²¹ In other words, low transaction costs reduce ex post “enforcement” costs.

315. In certain cases characterized by imperfect information with respect to the level of severity of a threatened legislation, firms are likely to reveal information that they would not have otherwise shared.

316. Incomplete contracts capture the idea that contracting is a costly process, and that this cost affects the ultimate features, scope, precision, and quality of the contract terms.

317. See generally Howard A. Shelanski & Peter G. Klein, *Empirical Research in Transaction Cost Economics: A Review and Assessment*, 11 J.L. ECON. & ORG. 335 (1995) (presenting an overview of the empirical research in transaction cost economics and enumerating sources of transaction costs in bargaining).

318. OLIVER HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* 21-24 (1995) (discussing contracting costs and contractual incompleteness).

319. Higher contractual durability reduces the likelihood and expected cost of renegotiation necessary to revise the agreement when future circumstances change.

320. Cf. Env't Agency, *Negotiated or Voluntary Agreements*, <http://www.environment-agency.gov.uk/business/regulation/31985.aspx> (last visited Jan. 13, 2009) (“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.”).

321. Reissuing a threat or—in some cases—exercising a threat ensures that firms do not neglect their contractual obligations. See, e.g., Winter, *supra* note 197, at A14 (noting how Representative Howard P. McKeon “warned he would restore the [Higher Education Act’s] penalties if universities appeared to slack off in their efforts to curb costs”).

Legislative threats also facilitate cooperation between targeted entities.³²² Directed towards professions and industrial sectors, for example, legislative threats generate strong incentives that propel groups to become organized.³²³ These forces lead group members to cooperate (e.g., minimize holdouts), gather information, and share this information with a legislator in the course of bargaining. Presumably, sharing information makes the parties well-positioned to tailor the most practical and efficient measures, making group members—and society at large—better off. Incorporating industry-wide and firm-specific information into the bargaining process is particularly valuable because it helps to avoid the inefficiency of erroneous or overreaching regulatory measures.³²⁴

Lastly, bargaining also improves a legislator's utility because it enables the parties to flexibly explore various measures and choose those that maximize their mutual gains.³²⁵ Specifically, negotiated measures may improve upon a legislator's initial demands for reform, achieve cost-effective social control, and maximize social welfare. Hence, bargaining may produce regulatory measures which are not only Pareto-superior to the threatened legislation, but which may also approach the Pareto frontier.³²⁶ A legislator's regulatory achievements are expected to enhance her reputation, to increase campaign contributions, and to improve voter satisfaction, all of which boil down to a higher chance of reelection. The rewards for advancing desirable policies and for effecting social change further reinforce a legislator's incentive to employ legislative threats as regulators of conduct.

322. See, e.g., *Unions See Signs of Breakthrough in Consultation Law*, EUR. REV., Sept. 1998, at 3, 4, available at <http://www.tueip.dircon.co.uk/er3-page3.html> (describing how a legislative threat on labor law was necessary to bring Europe's unions to the negotiating table); Editorial, *Mr. Baker Gets Tough*, TIMES (London), Nov. 1, 1986 (“[T]he threat of legislation to restructure the [teaching] profession will concentrate minds wonderfully when unions and employers meet . . .”).

323. While getting organized is certainly not cost free, it reduces the transaction costs of bargaining and increases the efficiency of the negotiated measures. See generally George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) (describing how transaction costs of regulatory bargaining include the costs of organizing).

324. Cf. Mosquera, *supra* note 80 (describing how industry groups told lawmakers that “sweeping regulations governing the collection and use of data” were not necessary to achieve regulatory goals (internal quotation marks omitted)).

325. A legislator's payoff from inducing a firm to comply and abandon its undesirable practices is 5. However, bargaining may result in significantly higher benefits.

326. A result is Pareto optimal—and therefore located on the Pareto frontier—if any other result can enhance the utility of one person, only at the expense of another. A result is Pareto-superior to an alternative if no one is made worse off by the result and the utility of at least one person is improved. See generally JULES COLEMAN, *MARKETS, MORALS, AND THE LAW* 95-132 (1988) (discussing Pareto optimality and utility).

CONCLUSION: THE LAW'S LIMITS AND THE CHALLENGE OF SOCIAL CONTROL

The U.S. economy has undergone a remarkable transformation in recent years with growth increasing at a roaring rate since the mid-1990s.³²⁷ The increase in society's wealth has many virtues, including better quality of life and higher standards of living, rising demand for products and services and lower unemployment, and higher returns and capital investment. Yet, economic growth and social progress are also mired in problems, which inevitably arise from the increasing speed of societal change. Technological advances, wealth of information, new sources of risk, and growing cross-border migration of people and work are but a few of the far-reaching transformations.

Nobel laureate and economist Douglass North has forewarned that "the process of growth is inherently destabilizing to a state."³²⁸ This is why absent effective social control, the same processes that drive well-developed market economies towards economic growth, technological advancement, and social progress might ultimately heighten social instability, propel economic decline, and lead to gradual societal deterioration.³²⁹ Hence, as society becomes more advanced and conditions change more rapidly, a lawmaker's role becomes far more demanding. Maintaining social order that allows for continued growth requires cost-effective rules and standards, legislative acumen and regulatory finesse, and, above all, a considerable amount of information.

Alas, lawmakers nowadays face severe difficulties, making their social control responsibilities virtually impossible to achieve. Specifically, legislators are frequently required to deal with insufficient data or, rather, with an unstructured wealth of information, inaccurate risk assessments and flawed impact projections, an inadequate understanding of relevant processes, correlations, and methods, and, above all, a lack of time and resources. Legislating effective regulatory measures necessary to promote sound policies therefore becomes all the more challenging. Moreover, as the activities and conditions that the law aims to control become more complex, legal rules become so too.³³⁰ The trend towards legal complexity affects the government as well, as the government "grows in complexity just as our society does."³³¹

In view of these problems, the law's tormented efficacy in controlling social conduct and in maintaining social order is only to be expected. In fact,

327. See generally Dale W. Jorgenson & Kevin J. Stiroh, *Raising the Speed Limit: U.S. Economic Growth in the Information Age*, BROOKINGS PAPERS ON ECON. ACTIVITY, Issue 1, 2000, at 125 (documenting and discussing causes of U.S. economic growth).

328. DOUGLASS C. NORTH, *STRUCTURE AND CHANGE IN ECONOMIC HISTORY* 29 (1981).

329. Cf. THRÁINN EGGERTSSON, *IMPERFECT INSTITUTIONS* 23-34 (2005) (arguing that imperfect social institutions can impede economic growth).

330. See EPSTEIN, *supra* note 300, at 21-36 (documenting the increasing complexity of legal rules).

331. EARL WARREN, *A REPUBLIC, IF YOU CAN KEEP IT* 67 (1972).

these trends underscore the growing incapacity of the legal system to deliver its preeminent promise: to maintain ordered liberty and to promote sound public policies. Moreover, the limits of the law and the limitations of lawmakers are bound to intensify. 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.”³³² Though universally valid, this concern is particularly alarming for American society, whose diverse aspects of social life and economic activity inextricably depend on a well-functioning legal system.³³³

The emergence and prevalence of legislative threats appears to be driven by the fact that the “[l]aw confronts unprecedented challenges today as it seeks to order an astonishingly dynamic American society.”³³⁴ Specifically, legislative threats surfaced as a spontaneous—that is, unplanned and unregulated—response to the functional limits of the law and systemic failures of lawmakers. Resorting to legislative threats, legislators can propel industry-wide reforms and prompt market-driven social control arrangements. Accordingly, legislative threats represent legislators’ effort to counteract the very forces that undermine society’s ability to adequately control the conduct of its members. Arguably, though, the institutionally unregulated and politically unaccountable use of legislative threats poses formidable normative challenges for the most treasured attributes of America’s constitutional democracy.

Viewed from an even broader perspective, the ever-increasing use of legislative threats seems to evince an increasing tendency towards *second-order social control*. Specifically, rather than dictate (i.e., first-order) rules of conduct and decide regulatory arrangements, legislators and regulators impose background (i.e., second-order) rules, designed to create the incentives necessary to *induce* firms and groups to devise desirable social control measures through self- or coregulation.³³⁵ In its deepest sense, the second-

332. PETER H. SCHUCK, *THE LIMITS OF LAW*, at ix (2000).

333. Cf. THOMAS BURKE, *LAWYERS, LAWSUITS, AND LEGAL RIGHTS 3-4* (2002) (“[T]he United States relies more than any other nation on lawyers, rights, and courts to address social issues”); Paul Barrett, *Civil Action: Why Americans Look to the Courts to Cure the Nation’s Social Ills*, *WALL ST. J.*, Jan. 4, 2000, at A1 (describing how litigation “is a central pillar of society”).

334. SCHUCK, *supra* note 332, at ix.

335. Instead of prescribing standards of conduct, the legal system may—rather counterintuitively—impose certain conditions to induce self or coregulation. For example, legislators may pass a risk-management legislation that shifts, reallocates, spreads, imposes, or even magnifies particular risks with respect to regulated entities. See DAVID MOSS, *WHEN ALL ELSE FAILS 292-93* (2002). Indeed, “[l]awmakers have frequently intervened [in risk-management], striving to reduce some types of risk outright and to reallocate numerous others.” *Id.* at 292. Employing the idea that changing the magnitude of risk affects ex ante incentives and behavior, this legislation may induce entities to conduct themselves so as to minimize risk exposure. Cf. Robert Cooter & Ariel Porat, *Anti-insurance*, 31 *J. LEGAL STUD.* 203 (2002) (proposing an insurance system to magnify risks in order to strengthen parties’

order approach to controlling social behavior highlights the pluralistic property of what game theorists John von Neumann and Oskar Morgenstern termed *the established order of society*: namely, when a comprehensive system of rules gives way to efficient, particular arrangements which derive from “general principles” but “differ among themselves in many particular respects.”³³⁶

The trend towards second-order social control inevitably diminishes the traditionally extensive role that the regulatory state has performed in directing social and economic life. At the same time, it increases the power possessed by groups that, in shaping and negotiating the regulatory environment in which they operate, may ultimately become the new social planners.³³⁷ This underscores the inevitable transformation of the post-New Deal regulatory state: the state’s role is relegated to setting policy objectives, while entrusting the design and adoption of particular, context-specific measures to private entities.³³⁸ Yet, unless the state can credibly commit itself to promoting consistent policy objectives and to ensuring entities’ compliance with these objectives, entities will have neither sufficient incentives to achieve these objectives, nor will they make the investment necessary to do so.³³⁹

The role the law plays—and that which it ought to play—in effecting social control must therefore be reexamined and reconceptualized. A society that fails to stand up to these challenges and disregards the ensuing pathologies runs the risk of heightened instability, economic stagflation, and social degeneration. Taken as a whole, the theoretical discussion presented in this Article is merely the beginning of a large and pressing set of problems. The thesis on legislative threats seems to have raised questions that deserve further study from both positive and normative perspectives. Whether legislative threats are desirable on normative grounds is one such issue. Another issue that lies at the heart of the matter is the manifold ways in which legislators and regulators can commit themselves to pursuing a stated policy, and, in the case of regulatory bargaining, to standing by their promises once these have been exchanged.³⁴⁰

incentives to reduce risk).

336. JOHN VON NEUMANN & OSKAR MORGENSTERN, *THEORY OF GAMES AND ECONOMIC BEHAVIOR* 41 (3d ed. 1953).

337. *Cf.* PATRICK BIRKINSHAW ET AL., *GOVERNMENT BY MOONLIGHT* (1990) (arguing that the state has transferred various public responsibilities to a spectrum of semiautonomous institutions).

338. This argument is consistent with trends observed in other social domains showing an increase in the scope and frequency of private-public partnerships. *See generally* Harold Demsetz, *The Private Production of Public Goods*, 13 *J.L. & ECON.* 293 (1970) (analyzing “the production of private goods through public means”).

339. 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).

340. For a related discussion that focuses on enforceability problems associated with political transactions, see generally W. Mark Crain et al., *Legislative Majorities as*

The thesis also directs attention to the design of political institutions.³⁴¹ In view of the intrinsic commitment problem, a question that merits additional inquiry is how these institutions should be designed so as to facilitate credible commitments across space and time.³⁴² Because these issues affect society's ability to control behavior and therefore bear decisively on individual well-being and social welfare, further study is warranted.

Nonsalvageable Assets, 55 S. ECON. J. 303 (1988).

341. 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 (i.e., "microlevel" effects), as well as "on the performance of the legislature" and on how effectively legislation "meet[s its] policy objectives" (i.e., "macrolevel" effects). KEITH KREHBIEL, *INFORMATION AND LEGISLATIVE ORGANIZATION 2* (1991).

342. This question has occupied economists. See, e.g., 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) (suggesting that "internal structure is an effective commitment mechanism"); 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 necessary to facilitate complex social contracts).