

HARNESSING THIRD PARTIES AS SURROGATE REGULATORS: ACHIEVING ENVIRONMENTAL OUTCOMES BY ALTERNATIVE MEANS



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The need to design innovative strategies alternative or complementary to that of government regulation is becoming increasingly apparent. This article examines one such innovation: to use both business and commercial entities and non-commercial third parties as surrogates for, or complements to, direct government regulation. This strategy will still involve government intervention, but selectively and in combination with a range of market solutions, and of public and private orderings. The contexts and circumstances in which third parties might be used as surrogate regulators are considered; the impediments to them acting in this role and the extent and circumstances in which they might be overcome are identified; and the roles that governments might play in facilitating, encouraging or otherwise ensuring that third parties do act successfully as surrogate regulators are examined.

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INTRODUCTION

One of the crucial issues of our time is how to avoid serious, and perhaps cataclysmic, damage to the natural environment. For policymakers, a variety of strategies are available that might, subject to political and economic constraints, enable serious environmental damage to be slowed down, halted or ideally reversed. Traditionally, one of the most important of those strategies has been environmental regulation.

However the strategy of using regulatory agencies to curb the environmental degradation caused by the behaviour of corporations and others is fraught with difficulty. Environmental regulation (particularly as enacted and enforced in the US) is sometimes inflexible, and excessively costly for business to comply with (Fiorino, 1996). Many of the quite considerable gains provided by traditional forms of regulation have been achieved at an unnecessarily high social and economic cost, and, in some cases, it has been demonstrably ineffective (Alm, 1992; Elliot, 1994; Orts, 1995). Pressures for governments to provide for more competitive business environments, and for business to keep up with rapidly changing technology, combine to further undermine the effectiveness of prescriptive government regulation. Even in jurisdictions such as the UK, where a more conciliatory and flexible regulatory style substantially mitigates some of these criticisms, traditional forms of regulation still have serious



limitations. Regulators have great difficulty visiting, let alone taking appropriate action to deal with many polluters, and their resource limitations are exacerbated in an age of fiscal constraint.

During recent years it has become apparent that it is necessary to devise a variety of innovative strategies alternative, or complementary to, that of government regulation. This article examines one such innovation: an alternative strategy for curbing environmental degradation that has the potential, at least in some circumstances, to make a very large contribution to environmental policy. This is to use both business and commercial entities and non-commercial third parties as surrogates for, or complements to, direct government regulation. This strategy will still involve government intervention, but selectively and in combination with a range of market solutions, and of public and private orderings.

If successful, the use of such third parties as surrogate regulators would have considerable benefits. It would take the weight off government regulation. It would provide more effective social control in at least some circumstances, and gain more social acceptance from regulated groups. Moreover it would provide more flexibility at less cost than conventional regulation. Yet the potential of this mechanism has so far not been systematically explored and it remains at the very early stages of development.

This article identifies the contexts and circumstances in which third parties might be used as surrogate regulators; it identifies the impediments to them acting in this role and the extent and circumstances in which they might be overcome; and it examines the roles that governments might play in facilitating, encouraging or otherwise ensuring that third parties do act successfully as surrogate regulators.

HARNESSING REGULATORY SURROGATES

Commonly, the regulatory process has been thought of as a dance between two participants – government and business, with the former acting in the role of regulator and the latter as regulatee. However, beneath the surface of this simplistic image lies a far more complex reality in which a wide variety of instruments can be used by a

multiplicity of regulatory participants and where informal social orderings play as significant a role as formal ones. Consequently, the traditional view of regulation as exclusively a governmental function is no longer immutable.

There are, in fact, a variety of third parties that can potentially be recruited to perform surrogate regulatory functions. However, this is a process with many pitfalls and, unless skilfully done, can result in negative rather than positive effects. We begin by identifying a number of very different types of third party and articulating in broad terms the actual and potential techniques that may be employed by each of them. We also examine: the extent to which, and means whereby, they may act as surrogate regulators; the opportunities for constructive interaction with other regulatory actors; and, importantly, how government can seek to effectively harness their activities.

Public interest groups

In most developed countries, public interest groups have become influential participants in the regulatory process. They have been instrumental in placing environmental issues high on the public agenda, and in keeping them there. A significant proportion of environmentally beneficial activity by government and industry only occurs because of the vigilance and the pressure exercised by public interest groups. Of course, no single group has a monopoly on the definition of 'public interest' and some so called 'public interest' groups have been industry sponsored organizations (such as the Climate Change Coalition in the US) whose goals are largely inconsistent with those of environmental protection. Nevertheless, the large majority of public interest groups, notwithstanding large differences of philosophy and style, do in various ways play a variety of constructive roles in protecting the environment.

For present purposes, we particularly focus on the roles public interest groups can play in strengthening the effectiveness of environmental policy instruments and as a force of informal social control in their own right and on how the judicious use of government policy can enhance both these roles. Among the most important contributions of environmental activists are: (i)



educating the community, (ii) providing information to regulators and regulatees, (iii) fulfilling a watchdog role, (iv) acting as private enforcers, (v) seeking compensation or preventing harm, and (vi) reforming the law (Gunningham and Grabosky, 1998). Such groups may also bring pressure to bear directly on companies and industries. This is an important example of the interaction between private parties that may, but need not, include a role for government, and of the potential for these groups to act as an informal instruments of social control.

Pressures exerted by interest groups on companies can be formidable – even in the absence of any government facilitation of their activity. For example, a highly successful Greenpeace campaign has been largely responsible for sensitizing European consumers (particularly in Germany and the UK) to the clear felling of old growth forests. This has had a profound impact upon North American companies exporting to those markets, who are increasingly being pressured by European buyers to provide evidence that the timber they supply has come from sustainably harvested sources. The emergence of the Forest Stewardship Council as a means of timber source certification is also increasingly influential in this regard.

The relationship between interest groups and industry is not, however, inevitably adversarial. Indeed, some of the most interesting developments in environmental policy involve industry – environmentalist partnerships. Such partnerships may take a variety of forms. 'Good neighbour agreements' between chemical industry firms and local residents are common in Europe and the United States. They feature means by which concerned citizens have access to information relating to regulatory compliance, and the right to inspect facilities and to review compliance and accident plans. Similarly, the World Wildlife Fund and the Wisconsin Potato and Vegetable Growers Association (an environmental organization and an agricultural commodity organization) have established a precedent-setting partnership to work towards more ecologically sound agricultural practices.

In recognition of the fundamental importance of industry cooperation in reducing environmental degradation, public interest groups are increasingly gearing their operations to maintain

an active dialogue with business (Long and Arnold, 1995). By strategically engaging highly visible market leaders, particularly those in consumer products industries, public interest groups hope to bring about not only improved environmental performance on the part of individual firms, but also entire industries: the visibility of the process can have an educative effect beyond the immediate participants. (Of course, industrial interest groups operate too and undoubtedly have a significant influence on the wider public consciousness on issues such as the role of science and technology.)

There are several ways in which government can facilitate the participation of public interest groups in the regulatory process (Grabosky, 1990). First, they may directly subsidize them. The extent to which public interest groups can make a contribution to the design and implementation of environmental regulation depends, at least in part, on their level of resourcing, which in turn may be related to government policy. Second, government may supplement directly the funding of public interest groups with financial incentives, and through taxation policy (for example, making contributions to such groups tax deductible). They could also, in order to actively encourage private enforcement, offer financial rewards to third parties for successful litigation. In the United States, for example, the *Clean Water Act* 1987 provides a modest incentive for citizen enforcement by allowing for recovery of costs incurred in enforcement litigation.

Third, government may provide greater access to the prime currency of public interest groups: information. Starved of information about the activities of industry, the state of the environment and government policy, their effectiveness will be severely curtailed. Public pollution databases provide community groups with increased political leverage both through the media and in plant level negotiations, enabling them to more effectively pressure polluters to reduce emissions. Fourth, government may improve the legal standing – the right to bring an action before a court – of public interest groups.

Fifth, while recognizing that some initiatives between public interest groups and business may take place entirely independent of government, governments may intervene in such a way as to nurture and facilitate constructive engagement



between business and NGOs (Gunningham and Grabosky, 1998). Necessarily, what is appropriate will vary with the circumstances of the case, but obvious possibilities include: government endorsement and public recognition for such initiatives; tax incentives or other financial support for those engaging in them; regulatory relief and flexibility where alternative means of achieving environmental outcomes can be demonstrated; and provision of a formal contractual underpinning for what would otherwise be informal and unenforceable arrangements. There is also ample opportunity for governments to engage environmental representatives in the process of establishing and operating self-regulatory and co-regulatory agreements with industry.

COMMERCIAL THIRD PARTIES

The role of commercial interests as surrogate regulators capable of shaping future environmental outcomes has been largely neglected in the literature on environmental regulation. Yet, as we shall see, their influence can be profound. In this section we identify these interests and explore their potential contribution in determining the environmental performance of industry. Our focus is on significant third-party non-governmental resources that can expand and strengthen the regulatory net, on circumstances where commercial environmentalism can act as a powerful institution of corporate social control and on the potential roles of government in facilitating or otherwise encouraging such initiatives.

Green consumers

There is evidence that some consumers, at least, may take environmental considerations into account when making purchasing decisions, but only if this does not involve any significant price differential between 'green' products and their less environmentally friendly competitors (Dawson and Gunningham, 1996, and references therein). Some may also favour products of manufacturers who have otherwise demonstrated concern for the environment. Companies which are in a position to demonstrate their credibility as environmentally responsible corporate citizens, and

thereby benefit from consumer preferences, may thus enjoy a competitive advantage (Stewart, 1992). Indeed, consumer preferences may be more exacting than government regulatory requirements. Substantial public relations and marketing advantages can flow from a legitimately earned reputation as an environmentally responsible company (Grabosky, 1994).

The purchase of environmentally preferable goods and services entails an implicit rejection of less acceptable alternative products. The boycott, or concerted avoidance, of certain purchases may be mobilized against products or producers deemed to be environmentally harmful. An example is the boycott of Norwegian fish products organized in 1993 by Greenpeace in protest against that nation's resumption of whaling. Boycott organizers maintained that the loss of foreign markets significantly exceeded the commercial value of Norway's whale catch. More recently, the establishment of independent certification of 'well managed forests' through the Forest Stewardship Council, a body whose existence owes far more to the initiative of major environmental groups than to government, gives paper and timber buyers considerable leverage over forest methods.

One of the clearest examples of the purchase of environmentally preferable products by consumers is organically grown produce. Organic production methods attempt to ensure the long-term sustainability of soil and water systems. They mitigate concerns over the impact of fertilizers and pesticides on human health, and provide an implicit rejection of the perceived negative influence of global agri-business (McRae *et al.*, 1993) and support the continued existence of an environmentally and culturally sustainable agrarian sector. Whatever their motivation, consumers of organic produce are willing to pay significant price premiums (upwards of 200% in many cases) for such products. Despite the often considerable price differential, the worldwide market for organic products is growing exponentially. In 1993 the worldwide market for organic products was worth US \$3.1 billion, a 223% increase on the 1992 figure (Campbell, 1996). More recent estimates place the market for organic produce in the US alone at being worth between US \$3.5 and US \$4 billion (Organic Farming Research Foundation, 1997; Organic Trade Association, 1998). The US



market is projected to be worth US \$6.6 billion by the year 2000 (Organic Trade Association, 1998).

While the purchase of organically grown food-stuffs may once have been seen as a fringe practice undertaken by only the most enlightened consumer, such a growth in the worldwide market has also alerted major food producers and commercial buyers alike to the increasing power of green consumers. In the UK, John Sainsbury PLC increased its organic product line by 50% in 1998, citing consumer demand as the major reason for such a policy change. Similarly, in response to what is becoming another significant area of green consumerism, seven of the EU's largest supermarkets (Sainsbury's and Marks & Spencer in the UK, Carrefour of France, Italy's Effelunga, Migros of Switzerland, Belgium's Delhaize and Superquinn of Ireland) announced in March 1999 that they would remove all genetically modified organisms (GMOs) and their derivatives from their own label products (*Daily Telegraph*, 1999). Shortly thereafter the British Retail Consortium (which represents 90% of UK retailers) announced that members would voluntarily label all products containing genetically modified derivatives, a move which exceeds the requirements of the *Food Labelling (Amendment) Regulations* (1999) (*The Times*, 1999).

However, the influence of 'green consumers' should not be overstated. The evidence suggests that consumers willingness to pay a higher price for green products is very uneven and there is a disturbing disparity between interviewees' purported willingness to seek out and buy green produce, and their actual behaviour. Indeed, the World Values Survey data reported by Richard Inglehart indicates that (with the possible exception of the Nordic Countries and the Netherlands) willingness to protect the environment remains low (although as indicated above, it is growing rapidly). As a result, in most countries in the majority of product categories, green consumerism is only a very modest influence. In those categories where it is a significant niche, specific products tend to be introduced and the rest of the products in that category do not change.

Moreover, an essential prerequisite to consumers exercising green preferences is access to reliable information that reflect products' relative environmental impact. The inevitable self-interest of manufacturers dictates that the source

of such information should be an independent party. This may be either a third party or government. As we have suggested, government can fulfil this role indirectly by enacting truth in advertising legislation, and directly by introducing eco-labelling programs. Environmental public interest groups can also certify 'green' products or organize boycotts, and in some cases retailers may provide green lines of products to their customers (Dawson and Gunningham, 1996).

Government can also use the power of consumption to favour environmentally preferable products through use of economic instruments, such as taxes and charges, which penalize products involving harmful inputs or practices. Government may directly influence manufacturers through their considerable purchasing power. In many markets, government is in fact the dominant purchaser, and the implementation of an environmental purchasing policy can have a major impact on market behaviour.

Buyer-supplier relations

The power of consumer preference is by no means wielded solely by the ultimate purchaser. Companies, driven by their own internal priorities, or mindful of their corporate image and their customers' preferences, commonly affect each other's behaviour. Purchasers often have leverage over suppliers which they may use to influence the latter's environmental performance. The interchange between business buyers and suppliers also generates incentives to innovate and to respond to market demands (Porter, 1990).

Larger firms, in particular, may be able to use their market power to impose product and process preferences on their smaller upstream suppliers and downstream buyers. For example, the Body Shop cosmetics retailer assists suppliers in self-assessment, and works with them to improve their environmental performance. At other times, it has been more adversarial, and more demanding – advising a supplier that they would consider increasing their purchases if the supplier were to adopt a formal environmental policy, publish a comprehensive audit report and end 'unnecessary confrontation with environmental groups'.

This capacity to influence small suppliers/buyers may prove very important, given the



difficulties confronting governments in applying conventional regulatory instruments to small enterprises. Some larger firms have taken steps to influence the behaviour of small firms through the practice of 'product stewardship', which entails environmental responsibility for the full life cycle of a product (Gunningham, 1995). In related development, the ISO 14001 environmental management standard may also come to be driven principally by supply-chain pressure. If so, the result will be that many enterprises, which would not choose to adopt such a system voluntarily, may nevertheless be prevailed upon to do so as a result of third party pressure, even in the absence of legislation mandating such a requirement.

Volvo, for example, asks that its suppliers comply with its environmental standards. In the chemicals sector, several prominent companies such as Dow Chemicals and Du Pont have introduced relatively sophisticated forms of product stewardship where suppliers are encouraged to meet high environmental standards, and have their performance assessed by independent auditors. Such relationships are inevitably unequal: large manufacturers are able to impose their standards on smaller suppliers and/or buyers. However, this is one of the few potentially effective ways of addressing the chronic weakness of many forms of environmental regulation in targeting small and medium-sized firms.

Another example of this trend (and of an increasing number of supply-chain partnerships) is the response to the growing demand for organic foodstuffs by Watties Frozen Foods in New Zealand (Campbell, 1996). Experiencing a serious shortage of certified organic growers who could supply the ever increasing demand for organic vegetables, Watties embarked in 1993 upon the 'Grow Organic with Watties' program to encourage farmers to switch from conventional to organic production methods. The program included regular newsletters, open days on organic farms and the provision of technical advice and expertise. The major benefit to growers was significantly higher prices for the contract supply of vegetables. In some instances, a contract to provide Watties with organic vegetables could carry a premium of 310% over the equivalent conventional product. The benefits to Watties Frozen Foods included price premiums of up to 100% in the lucrative Japanese export market and

enhanced market image as an environmentally progressive corporation. Indeed, Campbell indicates that the provision of an organic product line apparently also enhanced the 'clean green' image of Watties conventionally produced product lines.

There are several ways in which government can enhance the surrogate regulatory function of commercial third parties (Grabosky, 1995). Innovative regulatory approaches such as EMSs, co-regulation and flexible license and accreditation schemes may include provisions for product stewardship. For example, government could require accredited EMSs to include provisions that explicitly address buyer-supplier relationships – only those firms that complied would obtain more flexible cost effective forms of accreditation. Similarly, government could place a duty of care on producers to ensure, for example, that their wastes are handled and disposed of in an appropriate manner by registered contractors. Government sponsored 'green' award schemes could also recognize the contribution of upstream suppliers and downstream buyers. Corporate environmental reporting is another avenue where product stewardship could be encouraged through, for example, official government recognition of suitably comprehensive reporting systems. Economic instruments are also a potentially potent tool for sensitizing buyer-supplier relationships to environmental factors. By taxing environmental undesirables, for example the carbon content of fossil fuels, close to the source, an environmental price signal will filter through the entire downstream myriad of buyer-supplier relationships.

Institutional investors

Environmental performance is increasingly regarded as an indicator of wider business health. Good environmental management reflects good management in general. To the extent that this perception is shared by financial markets (and there is increasing evidence that it is), pressure on companies to improve corporate environmental citizenship will be that much greater (World Wildlife Fund, 1998). There is also the desire to avoid businesses that may face costs associated with environmental liability.

Market influence is further enhanced by regulatory requirements that shareholders and financial markets must be kept informed of



potential environmental liabilities. In the absence of disclosure requirements mandated by government, institutional investors themselves are increasingly in a position to demand that the companies in which they invest account for their environmental performance. However, credible and comparative information depends upon the development of appropriate performance measures that can be relied upon by the relevant stakeholders. As a particular performance measure is likely to be contestable, this is a complex area.

The extent to which investors are able to effectively discriminate between companies that do and do not have commendable environmental practices will ultimately determine the overall impact of environmentally responsible investment. Government can facilitate the potential good work of investors by ensuring that there are reliable sources of information about firm environmental performances for the market to access. Relevant examples include community right to know legislation and corporate environment reporting requirements. Of course, if private institutions can require disclosure and contribute to informed markets without assistance from government, so much the better.

Financial institutions

In addition to their activities as institutional investors, banks and other lending institutions are in a position to exercise considerable influence over their clients' behaviour. Lenders have a consistent record as effective regulators of business behaviour – particularly given the central role they play in the economy. Many now recognize the risk to their own commercial well-being posed by questionable environmental practices on the part of a borrower. Beyond the lender's obvious interest in the commercial viability of the borrower, banks must now be concerned about the environmental risks posed by any assets they might hold as security for a loan. In the event of foreclosure, banks could end up owning a liability rather than an asset (Schmidheiny and Zorroquin, 1996).

Schmidheiny (1992) predicts that an environmental audit report is likely to become an integral part of a bank loan application. One prospective lender already requires a comprehensive assessment of all risks associated with a proposed loan:

a 17-page environmental compliance checklist comprises part of the loan application. Canadian banks have begun to require detailed information from prospective commercial borrowers regarding all aspects of the latter's environmental exposure.

More broadly, a group of international banks, working with UNEP, has produced the Statement by Banks on Environment and Sustainable Development, which urges banks to

... expect, as part of our normal business practices, that our customers comply with all applicable local, national and international environmental regulations [and] will seek for business relations with suppliers and sub-contractors who follow similarly high environmental standards (UNEP, 1992).

Not surprisingly, the major way in which government can foster a 'green' lending philosophy among financial institutions is through strong environmental liability legislation, particularly if this involves strict, or even, exceptionally retrospective liability. Government can also contribute to more environmentally sensitive financial decisions by supplying information. For example, one way banks and other financial institutions might evaluate the environmental credentials of their would-be clients is through environmental reports, and financial institutions are increasingly cited as potential customers of such reports. However, they are at present discouraged by the diversity of reporting styles and lack of consistent and comparable data. By ensuring that enterprises report consistently on actual and potential liabilities, the capacity of financial institutions to assess and act upon their clients' environmental credentials would be considerably enhanced.

Insurance institutions

Provided it is possible to create a viable market, environmental insurance is a powerful policy tool. Just as financial institutions have become sensitive to the environmental performance of their borrowers, so too do insurers have strong incentives to control their policyholders. The availability of insurance, and the cost of insurance premiums, have begun increasingly to reflect a prospective policyholder's environmental record.



Schmidheiny (1992) has commented that companies with an unfavourable record of environmental compliance 'will find it increasingly difficult and expensive to get insured'.

In many cases, insurers now subject their policy holders to scrutiny beyond that which government authorities can bring to bear, and may hold their policyholders to standards well in excess of that which regulators are in a position to require. With poor environmental performers paying higher insurance premiums, the insurance market provides incentives for responsible corporate conduct, and disincentives for noncompliance (Katzman, 1985). More broadly, general insurance companies 'have a major role to play in effective management of the environment by helping industries understand the importance of preparing a risk management plan which addresses pollution reduction and avoidance. Without the plan, insurance will be difficult to obtain, and extremely expensive' (Jones, 1996).

In recent years, for example, marine insurance underwriters have been concerned about inadequate government inspection of maritime vessels, particularly those flying 'flags of convenience'. To compensate for this regulatory shortfall, and to ensure that the vessels they insure are indeed seaworthy, underwriters have engaged their own marine surveyors to inspect the vessels of prospective clients. Similarly, insurance underwriters in the oil and gas industry may engage specialized loss prevention consultants to advise on the insurability of particular activities and on the pricing of specific policies (Salter, 1993).

Insurance, however, is unlikely to realize its potential as an environmental policy tool in the absence of outside intervention. There has been a general withdrawal of cover for environmental impairment activities deriving from anything other than a sudden and accidental event, except in the case of a very limited number of industries and circumstances. As Freeman and Kunreather (1996) have pointed out, currently, most environmental risks do not satisfy the basic conditions of insurability and marketability: the ability to quantify the risk and to set premiums for each individual customer or class of customers.

A crucial role for government is to create the conditions conducive to private insurance functioning effectively. Specifically, this involves 'the

design of regulations and the creation of market conditions to permit the insurance industry to play a central role in environmental policy. In large measure, the government can both create and destroy the conditions that would permit insurance to be developed and sold' (Freeman and Kunreather, 1996). For example, if government specifies strict standards and provides the predictability that industry needs then insurance company inspectors can, *inter alia*, inspect against the legal standard and calculate risks in terms of it. Government can foster a regulatory role for insurance by requiring insurance as a condition of licensing, or as a condition of authorization to engage in activities that pose environmental risk.

Environmental consultants

The use of independent environmental consultants to assess and prescribe the environmental performance of firms has been a significant development in recent years. Environmental consultants vary widely in terms of the services they provide. Some are limited to specific industries, such as mining and agriculture. Others provide specific services such as audit and compliance monitoring. Larger and more diversified consultants provide a range of services, including risk assessment, training, process engineering, hazardous waste management and pollution prevention. Although the relationship between firms and consultants differs from other commercial third party situations in the sense that consultants are generally financially dependent on the patronage of firms, not usually the reverse, consultants can provide firms with significant commercial incentives. Specifically, their professional services are claimed to reduce exposure to litigation and criminal penalties, to improve risk management, operating performance and planning, to reduce costs through recycling, waste minimization and material substitutions (which might otherwise not be identified as viable) and to achieve environmental goals more efficiently and with less application of government resources (Gunningham and Prest, 1993).

There are also numerous ways in which government can positively encourage the use of environmental consultants, who may then work to improve their clients' environmental performance. Take environmental auditors as an example.



- (i) Government may directly subsidize environmental audits conducted, for example, by small and medium-sized business that would otherwise lack sufficient financial resources. This approach has been adopted in the UK.
- (ii) Government may provide tax incentives to undergo audits. This would potentially target a much wider range of firms, but may not be as an efficient and equitable use of public resources as direct subsidies.
- (iii) Through license accreditation systems, government may undertake to regulate more lightly those firms which voluntarily enter an audit scheme.
- (iv) Government may provide substantial public relations benefits to firms participating in a voluntary audit scheme, as has occurred under the EU's Environmental Management and Audit Scheme.
- (v) Government could provide preferential treatment to firms which have conducted an approved audit. This could take the form of preferential government purchasing or tendering, or preferential access to other government programs such as business improvement programs.
- (vi) Government and industry could build independent audits into self-regulatory or co-regulatory arrangements. For example, self-regulatory environmental covenants in the Netherlands require participating firms to have regular third party audits. Alternatively, co-regulatory agreements which contain provisions for product stewardship may encourage larger firms to audit smaller upstream suppliers and downstream buyers.
- (vii) Corporate environmental reporting may include provisions for independent environmental auditing, in a similar fashion to that required for financial reporting.
- (viii) Government may enact strong lender and insurance liability, which would encourage financial institutions to use external audits as a normal part of doing business.

In order to encourage the widespread use of environmental auditors, it may be necessary for government to ensure that the results of purely voluntary audits remain confidential, for example, by making audit results inadmissible in court. In

cases where audits are conducted as part of a co-regulatory scheme, or required as a result of regulatory compliance, and the results are consequently made available to regulatory authorities, then the same regulatory authority may undertake to give participating firms a 'period of grace' in which to rectify any identified problems.

GOVERNMENT'S ROLE

We have argued that both commercial and non-commercial third parties can play important roles in environmental protection. However, such participants will not necessarily order themselves to meet specific environmental objectives, and, in the absence of external intervention, many of the potential opportunities for third party intervention may never be realized. Thus there is an essential policy role for government to shape market orderings and to facilitate the constructive activities of non-governmental institutions. That is, at the same time as the state is retreating from many of its traditional regulatory functions, numerous opportunities arise to forge creative new roles, exploiting private institutions and resources in support of environmental policy.

Through the judicious use of incentives, or by wielding its purchasing power, government is able to structure a marketplace so that private transactions fulfil public purposes. As such, the behaviour of business can be guided at a distance by governments, and further conditioned by commercial and non-commercial third parties, to produce outcomes more advantageous than might be achieved by directions imposed through direct state intervention (Gunningham and Grabosky, 1998).

There are a number of legislative or administrative mechanisms by which the state may harness non-governmental resources in furtherance of regulatory goals (Grabosky, 1995). Since we have so far referred to these only indirectly, it may be useful to articulate them explicitly here. Following Gunningham and Grabosky (1998) Government may do the following.

- (i) *Conscript third parties to assist with some aspect of compliance.* Just as banks are required to report transactions over a certain threshold, so too can institutions be compelled by



law to disclose environmental breaches committed by others.

- (ii) *Require that targets of regulation engage the machinery of private institutions.* Mandatory environmental audit requirements are perhaps the best example. Similarly, government might require regulated entities to hold liability insurance as a condition of doing business, for example in circumstances of extreme environmental risk.
- (iii) With a view to informing markets or other private institutions in a position to foster compliance, *require disclosure of certain aspects of a regulatee's activities.* This is the basis for community right-to-know legislation.
- (iv) *Confer entitlements upon private parties,* leaving it up to those private parties to enforce those rights. For example, private enforcement provisions in laws that prohibit misleading advertising can be used by environmental groups against 'greenwash' tactics by some corporations. Alternatively, the government may empower third parties to undertake enforcement actions on the part of the state.
- (v) *Offer incentives directly to targets of regulation* to induce compliance, or to engage in a desired course of conduct, or they may also offer incentives to third parties for the co-production of regulatory services. Regulatory authorities may offer incentives for self-regulatory investments, or for the engagement of professional services that would foster compliance. Rewards and bounties to third parties for surveillance and enforcement activity are common in many regulatory systems.
- (vi) *Seek to engage private consultants* rather than rely upon information or services from organized interests. The state may also contract out one or more regulatory functions, from specialized testing to an entire regulatory regime. For example, the program for motor vehicle emissions testing in British Columbia was contracted out to private interests (Baar, 1993).
- (vii) *Accept standards developed in the private sector and give them official status.* In some regulatory systems, the task of developing rules is delegated to private interests. Considerable rule making function is delegated to

professional self-regulatory organizations. Galanter (1981) refers to such technologies as 'regulatory endowments'.

- (viii) *Relinquish a direct regulatory role in deference to market forces.* In this case, the role of government is to monitor the behaviour of markets, intervening only in the event of market failure.

To summarize, we have argued that governments can play an important role in catalysing forms of regulation that rely on more than the private sector. In some circumstances, this may imply a reduction in the need for public sector intervention, but this is clearly not the case in others. For example, government-based initiatives may generate the incentives that drive private action, and in this case public and private sector regulation are complementary rather than alternatives. As will be seen in the following section, commonly, what will be needed is the design of comprehensive policy mixes, rather than the complete replacement of one form of regulation (public) with another (private).

INTEGRATED REGULATORY DESIGN

The recruitment of a range of third parties as regulatory surrogates necessarily entails a significant departure from traditional modes of regulatory design. As such, it would be unwise to embark upon such a strategy without considering the broader implications for environmental policy. The capacity of third parties to deliver environmental improvements in industry will be maximized if their application is integrated and coordinated with other policy strategies through a series of regulatory reforms. Importantly, these reforms should be consistent with the need for policy to adapt to the new de-regulatory environment. We highlight below three critical reform steps that will assist in the application of surrogate regulators.

Comprehensive policy mixes

There are very few circumstances where a single regulatory approach is likely to be the most efficient or effective means of addressing a particular environmental problem. The best means of overcoming the deficiencies of individual policy



instruments, while taking advantage of their strengths, is through the design of combinations of instruments. Similar arguments for regulatory pluralism apply with regard to regulatory participants. In most jurisdictions, the regulatory process has been artificially restricted to government and industry. This reinforces outmoded notions of government as an omnipotent source of regulatory authority. A greater range of actors, including commercial third parties such as banks, insurers, consumers, suppliers and environmental consultants and non-commercial third parties, can assist in taking the weight off government intervention. Thus government can redirect its limited resources to those companies that are genuinely recalcitrant, and increasingly assume the mantle of facilitator and broker of third party participation in the regulatory process. An additional benefit is that a multiplicity of regulatory signals has the potential to be mutually reinforcing.

If one accepts this general approach of using combinations of instruments and participants, then there may be a temptation to succumb to a 'kitchen sink' approach to policy design, throwing in every conceivable policy combination on the assumption that the severity of the environmental problems we confront, and their likely consequences for humankind, are such as to justify almost any level of resource input (Hahn, 1993). However, this approach is likely to be seriously sub-optimal for a variety of reasons. First, there are practical limits to the capacity of industry to comply with a large range of regulatory and quasi-regulatory requirements – regulatory overload is now a well recognized phenomenon (Osborne and Gaebler, 1992). Second, the imposition on the public purse and the demand on public resources would also be excessive. Third and finally, not all combinations of instruments or institutions are likely to be complementary. On the contrary, a considerable number of combinations are either inherently, or in particular contexts, counterproductive, duplicative or sub-optimal.

Low intervention

There are a variety of reasons why less interventionist approaches should be preferred to more interventionist ones. In terms of *efficiency*, highly coercive instruments usually require substantial

administrative resources for monitoring and policing, without which they are likely to be ineffective. Highly prescriptive instruments lack flexibility and do not facilitate least cost solutions. They may also result in the unnecessary deployment of resources to policing those who would be quite willing to comply voluntarily under less interventionist options. Good performers may be inhibited from going beyond compliance with such regulation.

High intervention is unlikely to be as *effective* as alternative approaches essentially because constraints generally respond less favourably than volunteers. Highly coercive measures may cause resentment and resistance from those who regard them as an unjustifiable and intrusive intervention into their affairs, rather than the constructive resolution of environmental problems. Unsurprisingly, high intervention also tends to score very badly in terms of *political acceptability*. This is particularly the case in sectors with a history and culture of independence from, and a strong resentment of, government regulatory intervention.

Low interventionist options have the considerable advantages of providing greater flexibility to enterprises in their response, greater ownership of solutions which they are directly involved in creating, less resistance, greater legitimacy, greater speed of decision making, sensitivity to market circumstances and lower costs (Sigler and Murphy, 1989). From a regulator's perspective, a focus on less interventionist approaches also has the attraction of freeing up scarce regulatory resources, which may be redeployed against those who are unwilling or unable to respond to such measures and against whom there is no viable alternative to the deployment of highly intrusive instruments. Surrogate regulators provide an obvious opportunity for minimizing direct state intervention consistent with a preference for less interventionist measures.

Regulatory responsiveness

Although we advocate an emphasis on low interventionist measures, it is not always apparent to policy designers whether a particular measure they contemplate using will work or not, principally for two reasons. A given regulatory instrument may be effective in influencing the



behaviour of some, but not of others, or a particular regulatory instrument that prior to its introduction seemed likely to be viable in its entirety may in the light of practical experience prove not to be so. A window into solving this problem is provided by John Braithwaite's 'enforcement pyramid' (Ayres and Braithwaite, 1992). Under this model, regulators begin by assuming virtue (to which they respond with cooperative measures), but when their expectations are disappointed they respond with progressively punitive/coercive strategies until the regulatee conforms.

Central to Braithwaite's model is the capacity for gradual escalation from low to high intervention, culminating in a regulatory peak, which, if activated, will be sufficiently powerful to deter even the most egregious offender. It is possible to reconceptualize and extend this enforcement pyramid in two important ways. First, beyond the state and business, it is possible for third parties to act as surrogate regulators. Similarly, business may itself perform a self-regulatory role. Second, Braithwaite's pyramid utilizes a single instrument category, specifically, state regulation, rather than a range of instruments *and parties*. In contrast, it is possible to conceive of a regulatory pyramid using a number of different instruments implemented by a number of different parties.

In the event that an regulatory instrument that seems viable in its entirety turns out not to be so, one possible solution is to introduce *instrument sequencing*: enabling escalation from the preferred least interventionist option, if it fails, to increasingly more interventionist alternatives. For example, government could agree to a self-regulatory scheme with agreed performance benchmarks, with the proviso that, if and when these benchmarks are not achieved, a more interventionist policy response is automatically employed.

CONCLUSION

In this article we have argued that environmental policy is not immune from the forces of de-regulation, indeed some jurisdiction has already had serious implications for both the budgets and operations of regulatory agencies. Given that the fundamental drivers of

de-regulation, in particular globalization, privatization and competition reform, are unlikely to dissipate in the foreseeable future, and indeed may gather momentum, it is imperative that policy-makers adapt to this new environment.

Rather than embrace the rhetoric of the neo-liberal critics of traditional regulation, which espouses free market solutions and property rights, we consider that there is another way in which regulators can respond to de-regulatory pressures. This entails government complementing its traditional function as a direct intervener into the affairs of business, through the application of more conventional regulatory approaches, with regulatory surrogates. There is, in particular, a range of both commercial and non-commercial third parties that can provide considerable opportunities to extend the means of social control. To date, such regulatory surrogates have just begun to be exploited, certainly in the absence of any guiding strategy or principles.

It is important to recognize, however, that use of regulatory surrogates is unlikely to arise spontaneously. There remains a crucial role for government agencies in strategically and judiciously commandeering their application. In this way, government can retreat from more directly interventionist policies in circumstances where regulatory surrogates are employed, but reserve the right to intervene for those companies that prove to be genuinely recalcitrant or out of the reach of such surrogates. For this strategy to be successful, it will need to be integrated with other regulatory approaches, thus necessitating a number of reforms. These would include, in particular, the use of combinations of regulatory instruments and parties, a preference for starting with less interventionist approaches, and the capacity to respond to regulatory failure if and when it arises. It is our general conclusion that such a strategy would not only allow regulatory agencies to overcome the dangers of de-regulation, but, in so doing, leverage a range of regulatory participants that have been previously under-utilized.

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