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Sarah L. Stafford

*The College of William and Mary*

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Department of Economics
Working Paper Number 103

December 2010

COLLEGE OF WILLIAM AND MARY
DEPARTMENT OF ECONOMICS
WORKING PAPER #103
December 2010

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Sarah L. Stafford
Department of Economics
College of William and Mary
Williamsburg, VA 23187-8795
slstaf@wm.edu

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Sarah L. Stafford
Paul R. Verkuil Distinguished Professor of Economics, Public Policy, and Law
College of William and Mary, Williamsburg, VA

## I. Introduction

> "When the case for market-based approaches rests on axioms rather than analysis, the conversation becomes at once dull and dangerous." John Donahue[1]

In his book Outsourcing Sovereignty Paul Verkuil warns us to be wary of the possible threats to "democratic principals of accountability and process in what has been a largely unexamined shift from private to public governance."[2] Verkuil notes that the public and private sectors have different boundaries, and suggests that since outsourcing tests those boundaries, governments should "justify delegations of public power to private hands."[3]

This goal of this article is to examine one particular form of outsourcing – the outsourcing of regulatory enforcement to the regulated entities themselves, a practice known as self-policing – to determine whether this type of delegation of public power can be justified as being in the public interest. Part II offers an overview the particular concerns Verkuil and others have expressed regarding outsourcing in general. Next Part III provides a definition of self-policing and discusses both the theoretical justifications for this practice and as well as the potential pitfalls. Heeding the words quoted above, Part IV presents a case study of the Environmental Protection Agency's self-policing program, assessing the extent to which it is a defensible form of outsourcing. Part V reviews a number of other federal self-policing programs with a brief assessment of their strengths and weaknesses. Finally, Part VI suggests some general guidelines for self-policing programs to ensure that they are justifiable delegations of public power to private hands.

## II. The Concern Over Outsourcing

Privatization can generally be defined as "the practice of delegating public duties to private organizations."[4] The concept of privatization was initially imported from Thatcher's

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[1] John D. Donohue, "Market-Based Governance and the Architecture of Accountability," p. 3 in John D. Donohue and Joseph S. Nye, Eds. Market-Based Governance: Supply Side, Demand Side, Upside, and Downside Washington, D.C.: Brookings Institution Press, 2002.
[2] Paul R. Verkuil, Outsourcing Sovereignty: Why Privatization of Government Functions Threatens Democracy and What We Can Do About It, Cambridge: Cambridge University Press, 2007 [hereinafter Verkuil, Outsourcing], page 2.
[3] Verkuil, Outsourcing, page 1.
[4] John D. Donohue, The Privatization Decision: Public Ends, Private Means New York: Basic Books, Inc. 1989 [hereinafter Donohue, Privatization], p.3. This definition applies primarily

Britain in the early 1980s.[5] The movement flourished in the U.S. because of its resonance with two political trends taking place at the time: a rejuvenated interest in private enterprise and the push for decreased government spending in response to large budget deficits.[6]

The push for privatization or outsourcing[7] is based on the belief that the market can provide public activities either at lower cost than the government can provide them or can provide a more beneficial alternative at the same cost as the publicly provided alternative. If an action can be done more cheaply by the government than by the private sector, or if the government can provide a higher quality good or service than the private sector, there is no public benefit or justification for outsourcing. That is, proof that outsourcing lowers costs or increases benefits without increasing cost should be a necessary condition for endorsing it.

However, even if an activity can be done more efficiently by the private sector, privatization may not ultimately be in the public interest. Perhaps the most loudly voiced concern about outsourcing has to do with the potential loss in accountability that can occur when government functions are transferred to private agents.[8] The term accountability as used in this article means the ability of the public to demand an explanation or justification from an actor for its actions and to reward or punish that actor on the basis of its performance or its explanation.[9] Obviously for one's actions to be accountable, they must first be transparent. Privatized actions are generally less transparent than public actions, particularly since the Freedom of Information Act does not apply to private contractors.[10]

A second concern is that inherently governmental functions are currently being outsourced.[11] When a government delegates its sovereign powers to private entities, its

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to the U.S. In many other countries, the term is often used to denote the selling of public assets to private parties (see Donohue, Privatization, p.6).

[5] Donohue, Privatization, p.4.

[6] Donohue, Privatization, p.3.

[7] Following Verkuil I use the term outsourcing as a synonym for privatization (Verkuil, Outsourcing p.16, n.4).

[8] See Jody Freeman, The Private Role in Public Governance, 75 N.Y.U.L. Rev. 543, 2000 [hereinafter Freeman, Private Role], p. 574 (noting that private entities are one step further removed from direct accountability to the electorate, and that they remain relatively insulated from the legislative, executive, and judicial oversight to which agencies must submit) and Verkuil, Outsourcing p.7 (noting that given the current level of outsourcing, accountability is lacking).

[9] This is the same definition for accountability used in Verkuil, Outsourcing (p. 7, n. 38) and is generally consistent with Donohue's use of the term (see Donohue, Privatization, p. 23 "Accountability means that government action accords with the will of the people it represents.").

[10] Verkuil, Outsourcing, p. 105.

[11] The Federal Activities Inventory Reform Act of 1998 (Page 112 Stat. 2382, Public Law 105-270) defines the term "inherently governmental function" as "a function that is so

capacity to govern is diminished. The Constitution enumerates a number of activities that must be performed by particular branches of government.[12] In addition, the Federal Activities Inventory Reform Act of 1998 prevents agencies from contracting out inherently governmental activities.[13] However, most inherently governmental activities are not clearly defined, and thus there are concerns that some are currently being outsourced.[14]

A third concern is that privatization may reduce governmental capacity and thus impede the optimal evolution of public policy. As Jody Freeman notes, "[t]he process of [policy] design, implementation, and enforcement is fluid"[15] and public policy is constantly evolving. As regulators implement and enforce regulations, they collect information and experience that can be used to improve the next iteration of that regulation or related regulations. Under outsourcing, information or experience gained during the performance of an activity will accrue to private parties, rather than public employees. While some of this information or experience might be transferred to public agencies as part of the outsourcing contract, it is likely that some – perhaps most – is not. This loss of information and experience could interfere with the optimal evolution of policy and could also undermine the future performance of government agencies. A similar concern is that outsourcing may have serious implications for maintaining institutional knowledge within the government.[16]

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intimately related to the public interest as to require performance by Federal Government employees" including "activities that require either the exercise of discretion in applying Federal Government authority or the making of value judgments in making decisions for the Federal Government, including judgments relating to monetary transactions and entitlements".

[12] For example, the legislative power is entrusted to Congress in Article I while Article II, assigns executive power, the Commander-in-Chief function, appointment power, the power to conduct foreign affairs, and the granting of pardons to the President.

[13] Page 112 Stat. 2382, Public Law 105-270.

[14] Although the Office of Management and Budget is currently working on a new policy to provide uniform guideline for determining activities that must be performed by federal employees (See, "Work Reserved for Performance by Federal Government Employees: Proposed Policy Letter" 75 Fed. Reg. 16188 (March 31, 2010)) the policy will still leave a reasonable amount of discretion to agencies to classify activities. The concern that inherently governmental activities are being outsourced is a primary argument in Verkuil, Outsourcing.

[15] Freeman, Private Role, p. 572.

[16] Verkuil, Outsourcing p.4 (stating that one of the ways outsourcing undermines government performance is by atrophying government's power to perform these functions in the future) and p.6 (noting that outsourcing in DHS causes demoralization in the civil service and maintaining significant functions in-house is crucial to the preservation of the civil service).

Finally, there is the concern that outsourcing may lead to increased corruption by exacerbating the "revolving door" through which former government officials obtain positions in private contractors and vice versa.[17]

## III. The Case for Self-Policing

### A. What is self-policing?

There is no widely accepted formal definition of self-policing, perhaps because the term itself seems to be relatively self-explanatory. In the regulatory context, self-policing is essentially the delegation of enforcement responsibilities to the regulated entities themselves.[18] The delegation can be partial – that is, a regulator can allow facilities to self-police but continue to have a formal enforcement program as well – or complete.

Consider the following simplistic description of a purely public enforcement regime. In this regime public officials determine whether a regulated entity is in compliance by inspecting or auditing the entity. These inspections are not made on a set schedule nor is there any announcement prior to the inspection taking place. If the inspection or audit shows that the entity has violated a regulation, depending on the serious of the violation, the official may issue an informal notice or warning, initiate a civil administrative action under the agency's own authority, or refer civil or criminal judicial actions to the Department of Justice. Depending on the route taken, sanctions can be imposed through negotiated settlements or decisions by the court. Such sanctions require remediation of the violation (where applicable), and may include monetary penalties or incarceration in the case of criminal violations.[19]

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[17] Verkuil, Outsourcing p.5 and n.23 (noting that career officials are less likely to be corrupted because they have a long-term commitment to their agency and they are less likely to take advantage of outsourcing opportunities).

[18] This definition of the term self-policing is consistent with EPA's use of the term (see "Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations" 60 Fed. Reg. 66705 (December 22, 1995)) although EPA never formally defines the term. Other regulatory agencies do not necessarily use the term in the same way. For example the Securities and Exchange Commission uses the term self-policing to describe a company's voluntary auditing and compliance monitoring efforts, but doesn't include self-disclosure in the definition (see the SEC press release 2001-117 "SEC Issues report of Investigation and Statement Setting Forth Framework for Evaluating Cooperation in Exercising Prosecutorial Discretion," available at http://www.sec.gov/news/headlines/prosdiscretion.htm).

[19] This simplistic description is not an attempt to describe any particular enforcement regime, although it is generally consistent with EPA's enforcement regime (see generally, Robert Esworthy "Federal Pollution Control Laws: How Are They Enforced," Congressional Research Service Report to Congress RL34384, July 9, 2010 available at www.crs.gov [hereinafter Esworthy, Federal Pollution Control Laws]) and OSHA's enforcement process (see generally "OSHA Inspections," OSHA publication 2098, 2002 available at http://www.osha.gov/Publications/osha2098.pdf).

Under self-policing, regulated entities conduct "self-audits" to determine whether they are in compliance with the regulations.[20] The term self-audit merely means that the regulated entity makes the decision to audit, not that it necessarily conducts the audit itself. If the self-audit shows that the entity has violated a regulation, the entity reports that violation to officials who then decide how to proceed. Thus under self-policing, both the act of auditing and the disclosure of any discovered violations have been "outsourced" to the regulated entity. However, regulatory officials generally maintain responsibility for the imposition of any penalties or fines, as well as the determination of what the regulated entity must do to correct or remediate its violation.[21]

A key component of self-policing is that the decision to self-police is a voluntary decision. A mandatory requirement that regulated entities must conduct self-audits (or more generally must monitor performance) and report violations to authorities is not self-policing; such a requirement is an additional regulation with which a regulated entity can choose to comply, and which authorities will need to enforce.[22] For example, the Clean Water Act requires regulated entities to measure the level of pollutants in wastewater discharges and

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[20] I use the term "self-audit" to denote activities conducted by a regulated entity to determine whether the entity has violated any regulations. Self-audits are roughly equivalent to the concept of corporate enforcement costs employed in Jennifer Arlen, "The Potentially Perverse Effects of Corporate Criminal Liability." *Journal of Legal Studies*, Vol. 23, No. 2, 1994 [hereinafter Arlen, Perverse Effects], p. 835 (defining corporate enforcement costs as corporate expenditures on detecting and investigating crimes by employees).

[21] Some self-policing policies do specify the particular penalties or fines (or lack thereof) that will be imposed on self-disclosed violators. Although some fines may thus be automatic, regulatory officials are ultimately responsible for setting those automatic fines when the policy is established and presumable can choose to modify them.

[22] I use the term self-reporting to denote the requirement that regulated entities self-report information to an agency, which is consistent with the use of the term by Jon D. Harford, "Self-Reporting of Pollution and the Firm's Behavior under Imperfectly Enforceable Regulations," *Journal of Environmental Economics and Management*, 14:293-303, 1987 and Arun S. Malik "Self-Reporting and the Design of Policies for Regulating Stochastic Pollution," *Journal of Environmental Economics and Management*, 24:241-257, 1993. However, this distinction between the terms self-policing and self-reporting is not consistently used, at least within the economic literature on enforcement. For example, what I term self-policing others have called self-reporting (see Louis Kaplow and Steven Shavell "Optimal Law Enforcement with Self-Reporting of Behavior," *Journal of Political Economy*, 102:583-606, 1994 [hereinafter Kaplow and Shavell], p.453. "A commonly observed feature of law enforcement is what we shall call self-reporting of behavior: the reporting by parties of their own harm-producing actions to an enforcement authority. ") The two primary distinctions between self-policing and self-reporting as I use the terms are (1) that self-policing always pertains to a violation, while self-reporting can occur when a facility is in complete compliance, and (2) self-policing is voluntary while self-reporting can be mandatory.

report them to EPA or the state on a regular basis regardless of whether the emissions are within or exceed permitted limits.[23] Failure to adhere to permit limits results in one penalty if the violation is self-reported and a higher penalty if it is not reported or falsely reported and later discovered by authorities. The difference between the two penalties is thus the punishment associated with violating the reporting requirement.

There is, of course, nothing to stop a regulated entity from voluntarily reporting a violation of any existing regulation. However, in general profit-maximizing facilities will not voluntarily undertake costly self-audits and turn themselves in for discovered violations unless there is some type of inducement for doing so. The primary inducement used to encourage self-policing is a lower fine or penalty for self-disclosed violations than for violations detected by regulators through traditional channels (i.e., inspections or third party reports). A self-policing policy could also completely waive any fines associated with the self-disclosed violation.[24] A second type of inducement could be reduced external enforcement at the regulated entity – either in the same period as the self-disclosure or in future periods. The implications that both types of inducements can have for the costs and benefits of the self-policing policy are discussed in more detail in the next section.

Self-policing should not be confused with self-regulation, as self-regulation is a distinctly different activity (although this term also suffers from a lack of a widely accepted formal definition). Perhaps the most well-defined type of self regulation is "audited self-regulation" which has been formally defined as "congressional or agency delegation of power to a private self-regulatory organization to implement and enforce laws or agency regulations with respect to the regulated entities, with powers of independent action and review retained by the agency."[25] Thus under audited self-regulation regulated entities collectively develop regulatory standards which are then enforced by both the regulated entities and the agency. [26] In contrast, under self-policing regulated entities enforce standards established by the agency using the traditional rule-making process.

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[23] See generally, 40 CFR Part 122 for a description of the National Pollutant Discharge Elimination System (NPDES) and specifically 40 CFR Part 122(k)(4) for the reporting requirements.

[24] However, full reduction in penalties might induce entities to stop complying and self-police to avoid any fine. Of course, any positive payment to those self-policing could induce regulated entities to violate regulations deliberately in order to receive the payment for self-disclosure and thus should not be part of any self-policing policy where violations are the result the regulated entities' actions.

[25] This definition is provided in 1 C.F.R. s 305.94-1, "Recommendations Of The Administrative Conference Of The United States."

[26] While self-regulatory regimes generally include some form of self-policing, the development of standards by regulated entities is the focus the literature on self-regulation. For the purposes of this paper, we are not considering self-regulatory regimes.

## B. The Potential Efficiencies from Self-Policing

Over the past two decades, economists developed a wide range of theoretical models of self-policing regimes in order to study the welfare consequences of such regimes.[27] Not surprisingly, the results of these theoretical inquiries are sensitive to assumptions about the exact form that such regimes might take. Some models predict that self-policing allows regulators to shift enforcement resources from those who do self-police to other facilities, thereby increasing the level of compliance (which by assumption increases overall welfare[28]) for a given level of enforcement resources or alternatively allows regulators to achieve the same level of compliance for a lower expenditure of enforcement resources.[29] These benefits are analogous to the classic justification for privatizing many traditionally public functions, the ability to provide the same good or service – in this case compliance with government regulations – at a lower or cost or to provide a better good or service at the same cost.[30]

Other models have included the possibility of remediation as an element of self-policing and have found that the requirement to remediate a violation can produce additional welfare gains. To be precise, if a self-policing policy requires entities to remediate their self-reported violations, self-policing can also increase welfare because self-disclosed violations are remediated more quickly than violations discovered by regulators, and more

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[27] This summary of economic theories of self-policing draws extensively from the more detailed presentation of economic models of self-policing in Sarah L. Stafford, "Self-Policing in a Targeted Enforcement Regime," *Southern Economic Journal*, Vol. 74, pp.934-951, 2008 [hereinafter Stafford, Self-Policing]. Most of these models are framed in the context of environmental regulations, but they can be applied more generally to other regulatory programs.

[28] Throughout this paper, it is assumed implicitly that regulation itself is in the public interest and thus an increase in compliance with regulations will increase overall welfare. If regulation is misguided or if regulatory officials have been captured by special interests, in practice regulation may not be beneficial for society and thus increasing compliance may not increase overall welfare. In such cases, the problem is the underlying regulation, not the form of the enforcement regime.

[29] For example, Kaplow and Shavell present a theoretical model where regulated entities deliberately choose whether to comply or not and are subject to a positive probability of inspection (and thus detection of violations if the entity has chosen not to comply). The introduction of a self-policing regime in which entities that self-police receive a fine equal to the probability of inspection multiplied by the fine for detected violations induces some entities to self-police, but does not adversely affect deterrence. Self-policing thus increases welfare because enforcement effort is reduced as self-policers need not be inspected. Moreover, if individuals are risk averse rather than risk neutral, Kaplow and Shavell show that self-policing can lead to welfare improvements through the reduction of risk.

[30] In general, these models do not assume that self-audits are less costly than government audits. If that were the case, an additional benefit might be that the overall costs of auditing decrease, although that would depend on the assumptions and parameters of the model, as the total amount of auditing is likely to increase under self-policing.

violations will ultimately be remediated.[31] Additionally, to the extent that regulated entities that choose to violate regulations also engage in activities to conceal their violations, self-policing can increase overall welfare by reducing such activities.[32]

Of course, self-policing could have negative effects as well. Given the ability to self-police (and the inducements from doing so), some regulated entities may reduce their initial level of investment in compliance.[33] Moreover, policies that encourage self-policing can lead to duplication of effort (i.e., self-auditing by regulated entities and inspections by regulatory authorities) and thus be inefficient.[34] If regulators decrease enforcement efforts at regulated entities that self-police, entities could use self-disclosures as "red herrings," notifying regulators of small violations while concealing more significant violations.[35] Additionally, if regulators decrease future enforcement as a reward for a self-disclosed violation, entities may also decrease investments in compliance in the future.[36]

For regulations that apply to organizations (rather than regulations that apply to individuals), there is one additional rationale for allowing self-policing. Organizations subject to regulation must deal with the classic principal-agent problem: it is ultimately the organization's employees who determine the organization's compliance status and the organization has only imperfect means to induce the employees to act is accordance with

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[31] For example, the model of self-policing presented in Robert Innes, "Remediation and Self-Reporting in Optimal Law Enforcement," *Journal of Public Economics,* 72:379-393, 1999 assumes that regulated entities make a choice as to how much to invest in compliance, with the probability of a violation harm inversely related to the level of investment. If a violation occurs, the regulated entity can choose whether or not to remediate the harm. If regulators set the fine associated with self-policing at an appropriate level (i.e., so that the cost of remediation and the reduced fine is equal to the expected penalty and expected remediation cost), entities will self-police. Overall, the level of remediation will increase because self-policers remediate with certainty while non-disclosers only remediate when caught.

[32] See, for example, Robert Innes, "Violator Avoidance Activities and Self-Reporting in Optimal Law Enforcement," *Journal of Law, Economics, & Organization,* 17:239-256, 2001.

[33] The possibility for such an effect has been demonstrated in a wide variety of models including Anthony G. Heyes, "Cutting Environmental Penalties to Protect the Environment," *Journal of Public Economics* 60:251-265, 1996, Robert Innes, "Self-Policing and Optimal Law Enforcement When Violator Remediation is Valuable," *Journal of Political Economy* 107:1305-1325, 1999, and Stafford, Self-Policing.

[34] This potential effect is demonstrated by the model developed by Lana Friesen, "The Social Welfare Implications of Industry Self-Auditing," *Journal of Environmental Economics and Management* 51:280-294, 2006 [hereinafter Friesen, Self-Auditing].

[35] The use of the term "red herring" for this type of strategic disclosure – i.e., only partially disclosing an entity's violations – was introduced by Alexander S. P. Pfaff and Chris William Sanchirico, "Big Field, Small Potatoes: An Empirical Assessment of EPA's Self-Audit Policy," *Journal of Policy Analysis and Management* 23:415-432, 2004.

[36] The potential for self-policing to have dynamic effects on compliance is explained in Stafford, Self-Policing.

the organization's wishes.[37] Under strict vicarious liability, organizations are liable for all actions of their employees. However, as demonstrated by Jennifer Arlen, strict vicarious liability cannot induce organizations to both set optimal activity level and optimal levels of self-policing.[38] Allowing for self-policing within a strict vicarious liability regime does provide stronger (although potentially still sub-optimal) incentives for corporate policing of employee actions.[39]

All of the models described in this section are sensitive to the various assumptions they employ and do not tell us what actually happens in the real world when an agency adopts a self-policing policy. Still, the models suggest that, depending on how a self-policing policy is structured, self-policing can produce significant benefits, both by increasing compliance with regulations and reducing the cost of enforcement.

## IV. Case Study: EPA's Self-Policing Regime, the "Audit Policy"

### A. Description of the Audit Policy

EPA's self-policing policy, known informally as the "Audit Policy" was issued in December 1995.[40] Since the mid 1980's EPA had been working to encourage regulated entities to

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[37] While the economic models of self-policing discussed above do not explicitly model this principal-agent relationship, there are a number of models that assume that compliance is, at least in part, exogenous (e.g., Alexander S. P. Pfaff and Chris William Sanchirico, "Environmental Self-Auditing: Setting the Proper Incentives for Discovery and Correction of Environmental Harm," *Journal of Law, Economics, & Organization*, 16:189-208, 2000; Friesen, Self-Auditing; and Stafford, Self-Policing). Such models can be viewed as representing the classic principal-agent problem between organization and employees vis-à-vis compliance activities in that the organization does not have the ability to insure full compliance itself.

[38] See Arlen, Perverse Effects, pp. 842-842 for a discussion of the "perverse incentives" strict vicarious liability provides for self-policing efforts (which Arlen refers to as corporate enforcement costs) because self-policing will, in addition to deterring violations by employees, increase to probability that a organization's violations are detected, thus increasing the organization's expected liability and pp. 847-848 for a discussion of the inability of strict liability to induce optimal levels of both activity and self-policing efforts.

[39] See Jennifer Arlen and Reinier Kraakman, "Controlling Corporate Misconduct: An Analysis Of Corporate Liability Regimes." *New York University Law Review*, Vol. 72, Rev. 687, 1997 [hereinafter Arlen and Kraakman], p.4, "duty-based liability is generally better able to induce firms to undertake optimal policing measures such as monitoring, investigating, and reporting." (On page 2 of the same article a duty-based regime is defined as one similar to that of the EPA which "immunize[s] firms from liability for internally detected environmental violations that firms disclose and correct.")

[40] "Incentives for Self-Policing: Discovery, Disclosure, Correction, and Prevention of Violations – Final Policy Statement," 60 Fed. Reg. 66706 (December 22, 1995). Minor revisions to the policy were issued under "Incentives for Self-Policing: Discovery,

adopt effective environmental auditing practices, as the Agency believed that environmental auditing could significantly improve environmental performance.[41] Initially EPA tried to encourage environmental audits by suggesting that EPA would take auditing efforts into account when assessing violations, "particularly when a regulated entity promptly reports violations or compliance data which were otherwise not required to be recorded or reported to EPA."[42] As the policy evolved, the rewards for self-disclosures became more explicit, and the requirement that disclosures arise from an environmental audit were softened. The final policy that emerged is a self-policing policy rather than a policy on environmental auditing per se, but it is commonly referred to as the Audit Policy because EPA's initial objective was to encourage environmental auditing. Additionally, the Audit Policy is a policy rather than a formal rule.[43]

Under the Audit Policy, any entity that voluntarily identifies, discloses, and corrects violations of environmental regulations is eligible for a reduction in the punitive penalties associated with those violations.[44] To be eligible for a complete waiver of punitive penalties the self-disclosure must meet nine conditions:[45]

- Systematic discovery: discovery must either take place during an environmental audit or during a self-evaluation that is part of a due diligence program.

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Disclosure, Correction, and Prevention of Violations – Final Policy Statement," 65 Fed. Reg. 19618 (April 11, 2000) [hereinafter Audit Policy].

[41] "Interim Guidance on Environmental Auditing Policy Statement," 50 Fed. Reg. 46504 (November 8, 1985) ) [hereinafter Interim Guidance]. This guidance defines environmental auditing to be "a systematic, documented, periodic and objective review by regulated entities of facility operations and practices related to meeting environmental requirements. Audits can be designed to accomplish any of all of the following: verify compliance with environmental requirements; evaluate the effectiveness of environmental management systems already in place; or assess risks from regulated and unregulated materials and practices." EPA's belief that environmental auditing would be beneficial was based primarily on anecdotal evidence. See, for example U.S. EPA, "EPA/CMA Root Cause Analysis Pilot Project: An Industry Survey," May 1999 (presenting results of a study in which many respondents identified the use of self-audits or third party audits as an important method for improving compliance).

[42] Interim Guidance, Section III.B.1.

[43] Audit Policy, Section II.G.3, "The Policy is not final agency action and is intended as guidance. This Policy is not intended, nor can it be relied upon, to create any rights enforceable by any party in litigation with the United States. As with the 1995 Audit Policy, EPA may decide to follow guidance provided in this document or to act at variance with it based on its analysis of the specific facts presented. This Policy may be revised without public notice to reflect changes in EPA's approach to providing incentives for self-policing by regulated entities, or to clarify and update text."

[44] Audit Policy, Section II.C.1.

[45] Audit Policy, Section II.D.

- Voluntary discovery: the process though which the violation is discovered cannot be required by federal, state or local authorities and cannot be required by statute, regulation, permit or consent agreement.
- Prompt disclosure: violations must be disclosed within 21 days of discovery.
- Independent discovery and disclosure: the disclosure cannot be made after an inspection or investigation has been announced or notice of a suit has been given.
- Correction and remediation: any harm from the violation must be remediated and the violation must be corrected within 60 days of the date of discovery unless technological issues are a factor.
- No recurrence: the facility must identify why the violation occurred and take steps to ensure that it won't recur.
- No repeat violations: the same or a closely related violation can't have occurred within the past three years at the facility or within the past five years at other facilities owned by the same parent organization.
- Not excluded: no serious harm or imminent endangerment to human health and the environment can have occurred as a result of the violation and the violation cannot have been a violation of an order, consent agreement, or plea agreement.
- Cooperation: the facility must cooperate with EPA, including providing all requested documents.

If the disclosure meets all but the first condition, the punitive penalty is reduced by 75% rather than 100%.[46] Additionally, as long as no actual harm has occurred, EPA will not recommend criminal prosecution of the regulated entity unless EPA determines that the violation is part of a pattern or practice that demonstrates or involves "(i) A prevalent management philosophy or practice that conceals or condones environmental violations; or (ii) High-level corporate officials' or managers' conscious involvement in, or willful blindness to, violations of Federal environmental law."[47] The conditions for a self-disclosed violation to be eligible for penalty reductions are designed to ensure that the policy increases overall compliance and does not undermine the existing enforcement regime.

It is important to note that the regulated entity cannot receive any reduction in penalties that are based on the economic benefit gained from noncompliance, only a reduction in penalties that are punitive in nature. [48] For example, if a facility neglects to sample a particular waste stream for several months and discovers this violation through an environmental audit, assuming the violation meets all of the conditions above, the facility would receive a complete reduction in the punitive portion of the penalty but would continue to owe a penalty equal to the savings it received from not having conducted those samples. This requirement is necessary to ensure that regulated entities have no incentive to deliberately violate and then self-police. In the example above, there would be no

[46] Audit Policy, Section II.C.2.
[47] Audit Policy, Section II.C.3. This applies only to the regulated entity, not to any managers or employees.
[48] Audit Policy, Section II.E.

benefit to deliberately not sampling and then self-policing if the regulated entity has to pay the cost of sampling after disclosure.

During the development of the Audit Policy, EPA repeatedly sought comments from the regulated community. One commenter on an early version of the policy suggested that EPA should commit to taking audits into account when assessing enforcement actions. In response, EPA stated that agreeing to forgo inspections or reduce enforcement responses is "fraught with legal and policy obstacles."[49] However EPA also noted that, because effective audit programs should improve compliance, facilities that audit should have improved environmental performance, which is likely to be considered in setting inspection priorities. Such language is consistent with statements on EPA's web site that when facilities self-police, it can render "formal EPA investigations and enforcement actions unnecessary."[50] This statement implies that, as well as rewarding self-policers with reduced penalties, EPA's Audit Policy may provide additional incentives in the form of reduced enforcement.

Throughout the development of the Audit Policy, EPA consistently refused to grant privilege to environmental audits privilege as that would be "counter to efforts to open up environmental decision making and encourage public participation."[51] Additionally, EPA was concerned that environmental audit privilege could be misused to "shield bad actors or frustrate access to crucial factual information."[52] However, EPA has repeatedly stated that its long-standing practice is to not request copies of regulated entities' voluntary audit reports.[53]

## B. Analysis of the Audit Policy

### *i. General Information of the Use of the Audit Policy*

EPA consistently publicizes the Audit Policy as one of its successful, innovative approaches to compliance.[54] To get a sense of the role the Audit Policy plays in EPA's overall

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[49] See the "Final Policy Statement," 51 FR 25004 (July 9, 1986), Section I.
[50] See http://www.epa.gov/compliance/incentives/auditing/index.html, last accessed September 21, 20010.
[51] "Voluntary Environmental Self-Policing and Self-Disclosure Interim Policy Statement", 60 FR 16875, (April 3, 1995); quote on page 16878.
[52] Ibid, quote on page 16878.
[53] Audit Policy, Section II.C.4.
[54] For example, in the introduction to EPA's Fiscal Year 2002 Enforcement and Compliance Assurance Report, "Environmental Results Through Smart Enforcement," (available at http://www.epa.gov/compliance/resources/reports/accomplishments/oeca/fy02accomplishment.pdf) Assistant Administrator John Peter Suarez included the 26 percent increase in companies' self-reporting violations as one of the highlights of the year. EPA's 2006-2011 EPA Strategic Plan (available at http://www.epa.gov/ocfo/plan/plan.htm) listed self-policing as one of four key components of its enforcement plan.

enforcement regime, there are over one million entities that are subject to EPA regulation.[55] In 2009, federal and state regulators conducted about 20,000 regulatory inspections and evaluations, wrote about 3,500 administrative compliance and penalty orders, made about 280 civil judicial referrals and opened just under 400 criminal cases. During this same time frame there were about 1,200 self-disclosures. [56] Of course, there could be many more entities that "self-policed" but found themselves to be in complete compliance and thus had nothing to disclose.[57]

Two researchers, Alexander Pfaff and Chris Sanchirico conducted an analysis of disclosures made under the Audit Policy from 1994-1999 and found that the majority of disclosed violations were reporting and recordkeeping violations.[58] I found a similar result when I conducted an analysis of disclosures made between 1994 and early 2002.[59] Although the initial reaction might be to think that a self-policing policy that only results in the disclosure of minor violations cannot be effective, that is not necessarily the case. One of the primary reasons for having an enforcement policy is to deter regulated entities from violating regulations. However, potential violators will only be deterred by the threat of punishment if the decision to violate is based on rational comparison of the cost of compliance compared to the expected cost of a violation. If regulated entities violate not because they are "rational violators" but rather because they are mistaken or confused

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[55] Data on regulated facilities were compiled by author using EPA's Envirofacts Database.
[56] Disclosure and inspection data from "Enforcement and Compliance Assistance Results: Numbers at a Glance Fiscal Year 2009," http://www.epa.gov/compliance/resources/reports/endofyear/eoy2009/2009numbers.html.
[57] Disclosing that you are in compliance is not an option under the Audit Policy and from a theoretical standpoint it probably should not be. If such disclosures do not change future enforcement behavior, then making them only increases the costs of implementing the policy, as the disclosures have to be recorded. If there were a reward for making such disclosures (such as reduced future enforcement) then EPA would need to institute a process to verify those disclosures (otherwise entities would falsely disclose compliance in order to receive the reward). There is no reason to expect that the verification process would be less resource intensive than a traditional enforcement inspection, and thus it is difficult to construct a situation in which such a regime would increase overall compliance relative to a traditional enforcement regime.
[58] Alexander Pfaff and Chris Sanchirico. "Big Field, Small Potatoes: An Empirical Assessment of EPA's Self-Audit Policy," Journal of Policy Analysis and Management Vol.23, 2004, pp.415-432.
[59] The analysis covered the 236 disclosures that were entered into EPA's Audit Docket (HQ-OECA-C-94-01). The Audit Docket initially served as a repository for all disclosures made under the Audit Policy. Around 1998, EPA stopped placing all disclosures in the Audit Docket, and by early 2002 EPA was no longer using the Audit Docket at all. Thus the 236 disclosures in the docket may not be a representative sample.

about how to comply, enforcement will not deter them from violation.[60] If such entities can be brought into compliance by self-policing, enforcement resources can be redirected away from confused violators toward rational violators, increasing the overall level of deterrence without increasing enforcement resources. One may also think that confused violators are much more likely to make small mistakes such as record-keeping or reporting errors. If this is the case, then one should not be surprised at the types of violations that are being reported.

Under the Audit Policy, EPA does give self-disclosers a significant penalty reduction. During the 2001-2005 period, over two-thirds of all disclosures resulted in a complete waiver of all penalties.[61] In addition, the likelihood of a regulatory inspection decreases significantly following a self-disclosure. The results of an analysis I conducted on self-disclosures and inspections at facilities subject to EPA's hazardous waste regulations found that on average, a self-disclosure in 2001 from a facility regulated under EPA's hazardous waste program reduces the probability of inspection in 2002 by four-fifths.[62]

*ii. Effect on Compliance and Enforcement*

From the beginning of its development, opponents of the Audit Policy argued that it would have a detrimental effect on the environment because it protected polluters from punishment and decreased the incentives for entities to comply with regulations. To assess the overall effect the Audit Policy had on compliance, I conducted an analysis of the effect of the Audit Policy on compliance with hazardous waste regulations.[63] The analysis uses data on detected hazardous waste violations and EPA enforcement actions to determine statistically if there has been an underlying change in the compliance behavior of regulated entities. The results provide little evidence to support the theory that compliance has decreased as a result of the Audit Policy. According to the results of my study, the federal Audit Policy has had no measurable effect on compliance behavior while state self-policing

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[60] A more detailed discussion on these ideas is provided in Sarah L. Stafford, "Rational or Confused Polluters? Evidence from Hazardous Waste Compliance," in *Contributions to Economic Analysis and Policy*, Vol. 5: No. 1, Article 21 (2006).

[61] Calculations made by author using information from EPA's database of voluntary disclosures for Fiscal Years 2001-2005 obtained under a Freedom of Information Act request.

[62] Sarah L. Stafford, "Should You Turn Yourself In? The Consequences of Environmental Self-Policing," *Journal of Policy Analysis and Management*, Vol. 26, 2007, pp.305-326 [hereinafter Stafford, Turn Yourself In].

[63] See Sarah L. Stafford, "Does Self-Policing Help the Environment? EPA's Audit Policy and Hazardous Waste Compliance," *Vermont Journal of Environmental Law*, Vol. 6 (2005) [hereinafter Stafford, Does Self-Policing Help]. The analysis only considers compliance with hazardous waste regulations because the separate programs that regulate air, water, toxic materials, and hazardous waste all maintain their own enforcement authority and it is very difficult to combine data across the various enforcement programs.

policies and state audit privilege legislation have decreased the probability of violation.[64] Interestingly, state legislation that provides complete penalty immunity for self-disclosed violations increases the probability of a violation. In this study I also examine inspection before and after the imposition of the Audit Policy.
I also conducted a second study using a different data set to examine the consequences of self-policing for facilities that self-disclosed under the Audit Policy.[65] The primary focus of this analysis was to examine the effect that a self-disclosure has on future inspections to determine whether self-policers were being rewarded with a decrease in future enforcement. As discussed above, I did find that self-policers are rewarded with a lower probability of enforcement following a disclosure. One implication of this finding is that the Audit Policy may induce entities to strategically disclose violations in order to advantage of the "enforcement holiday" that follows a disclosure.

Michael Toffel and Jodi Short examine the effect of the Audit Policy on firm compliance with Clean Air Act regulations, rather than hazardous waste regulations, and find similar results.[66] Their analysis concludes that self-disclosers have lower levels of abnormal releases and higher compliance rates in the five years following their disclosure. They also find that regulators grant "inspection holidays" to facilities that self-police.

A recent study conducted by Santiago Guerrero and Robert Innes also provides some interesting evidence on the effect of self-policing on environmental performance.[67] This study examines the effect of state self-policing policies and environmental audit legislation (rather than EPA's Audit Policy) on changes in toxic emission levels (rather than violations of environmental regulations).[68] Additionally, while the study considers overall levels of toxic emissions, it only examines enforcement efforts related to the Clean Air Act, not overall enforcement efforts. Similar to the results I found in my study of hazardous waste compliance, their analysis shows that state self-policing policies and audit privilege

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[64] In addition to the federal Audit Policy, a number of states have passed their own self-policing policies as well as immunity and privilege legislation for environmental audits. The state policies are discussed in more detail in Sarah L. Stafford, "State Adoption of Environmental Audit Initiatives," Contemporary Economic Policy, Vol. 24, 2006, pp.172-187.
[65] See Stafford, Turn Yourself In
[66] Michael W. Toffel and Jodi L. Short Coming, "Clean and Cleaning Up: Is Voluntary Self-Reporting a Signal of Effective Self-Policing?" Harvard Business School Working Paper, 08-098 (2010) available at http://www.hbs.edu/research/facpubs/workingpapers/papers0708.html#wp08-098 (last accessed October 1, 21010).
[67] See Santiago Guerrero and Robert Innes, "Statutory Rewards to Environmental Self-Auditing: Do They Reduce Pollution and Save Regulatory Costs? Evidence from a Cross-State Panel" Working Paper available at http://rdinnes.com/research/ (last accessed October 1, 2010) [hereinafter Guerrero and Innes, Statutory Rewards].
[68] While decreases in toxic emissions certainly affect environmental quality, they are not necessarily indicative of higher levels of compliance, as regulated entities can emit toxic materials in full compliance with environmental regulations.

legislation lead to lower levels of toxic emissions while legislation that provides complete immunity from state penalties lead to increases in toxic emissions. Innes and Guerrero also find that state self-policing and privilege protections lead to reduced rates of Clean Air Act inspection, while complete immunity spurs increased inspection levels. While these results are not specific to EPA's self-policing policy, they do suggest that the blanket provision of complete immunity (something that EPA's Audit Policy does not do) is not beneficial to the environment. The authors speculate that complete immunity reduces entities' incentive to avoid environmental violations in the first place, thereby increasing overall pollution. Moreover, the results suggest that regulators must increase their monitoring of regulated entities to respond to the reduced incentives.

Taken together, these studies indicate that EPA's Audit Policy increases compliance and performance, or at a minimum, does not decrease it. Given that overall environmental enforcement resources decreased over the time frame of these analyses,[69] there is thus reasonable evidence that the efficiency of EPA's enforcement program has increased under the Audit Policy.

*iii. Potential "Outsourcing Concerns"*

Even though the analyses of EPA's show that self-policing increases compliance, and thus by assumption overall welfare[70], there could still be good reason to reject it. Part II presented four potential concerns about outsourcing that have been identified by various scholars of the law and public policy. This section examines and evaluates those possible objections to self-policing, drawing on the content of the EPA's Audit policy and the experience with its operation.

a. Accountability

The first issue is accountability, more specifically the potential loss in accountability that can occur when government functions are transferred to private agents. Ideally, if there were full accountability, public actions would be consistent with public interest, although in practice accountability means that the public knows what actions are being taken and can effect changes in those actions if they are not consistent with the preferences of the public.[71] Thus accountability is closely tied to the idea of transparency – for the public to hold someone accountable, they must first know what that individual has done.

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[69] See Wayne B. Gray and Jay P. Shimshack, "The Effectiveness of Environmental Monitoring and Enforcement: A Review of the Empirical Evidence" forthcoming in the Review of Environmental Economics and Policy, Figure 1, documenting the decrease in EPA enforcement resources from 1994 to 2010.

[70] See supra note 28.

[71] See Donohue, Privatization, pp. 23-24, ("Accountability means that government action accords with the will of the people it represents. … Yet, even assuming the best intentions on the part of public decision-makers, making that principle effective in collective choice is an elusive ideal.").

How transparent is the Audit Policy? All disclosures granted relief under the Audit Policy are made publicly available after the disclosure has been settled, as well as the terms of the settlement (i.e., any penalty reductions).[72] Initially disclosures were entered into the Audit Policy docket, although this practice is no longer being used and no new cases have been added into the docket since early 2002.[73] EPA does provide data on the total number of disclosures each year in an annual report, but to obtain data on individual disclosures, one must submit a Freedom of Information Act (FOIA) request.[74] Thus one might fear that the accountability of EPA's enforcement system is reduced by the Audit Policy. However, enforcement by EPA is not necessarily any more transparent than the Audit Policy. Aggregate information on inspections and violations are provided each year in the same annual report that provides data on the number of disclosures.[75] Some data on a particular regulated entity's compliance and enforcement status is available from an database available on EPA's website, but to obtain complete data on an entity's compliance history or a list of entities that had been inspected or prosecuted for violation of a particular environmental regulation, one would most likely have to file a FOIA request.[76]

Even if there were additional transparency with respect to the Audit Policy (or for that matter enforcement in general), enforcement is much less accountable than other parts of the public policy process as there is no formal role for public participation in the development or implementation of an enforcement protocol.[77] Since EPA lacks the resources to inspect all regulated entities or even to pursue cases against all those that are fond in violation, there is significant agency discretion to determine how to deploy

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[72] Audit Policy, Section II.H, "EPA will make publicly available the terms and conditions of any compliance agreement reached under this Policy, including the nature of the violation, the remedy, and the schedule for returning to compliance."

[73] Examination of EPA Docket HQ-OECA-C-94-01 by author, conducted in 2004.

[74] The annual aggregate numbers are available in the "Numbers at a Glance" Section of EPA's Office of Enforcement and Compliance Assistance report on Annual Results, available at http://www.epa.gov/compliance/data/results/annual/index.html (last accessed September 30, 2010).

[75] The annual aggregate inspection and violation data is also available in the "Numbers at a Glance" Section of EPA's Office of Enforcement and Compliance Assistance report on Annual Results, available at http://www.epa.gov/compliance/data/results/annual/index.html (last accessed September 30, 2010).

[76] See EPA's Enforcement and Compliance History Online (ECHO) database, available at http://www.epa-echo.gov/echo/. ECHO provides compliance and enforcement data for approximately 800,000 regulated facilities nationwide. The data set includes inspection, violation, enforcement action, informal enforcement action, and penalty information about facilities for a three-year window.

[77] Unlike to rulemaking process, there is no formal public participation in the development or implementation of an enforcement protocol. Additionally, courts are reluctant to review the exercise of enforcement discretion (see Freeman, Private Role, p.648 and n.431).

enforcement resources.[78] Moreover, in those cases that are pursued, parties may settle or enter into consent decrees, negotiating the terms of their ultimate "compliance" with the regulations with little to no public input into the process. Perhaps as a response to this relative lack of accountability in enforcement, one feature of most environmental statutes is a private right of action for individuals (or groups) to sue regulated entities for violations of the regulations.[79] This mechanism for direct accountability to the community is not affected by the self-policing policy.[80]

Given the high level of agency discretion and low level of accountability in EPA's public enforcement regime and the lack of any evidence that the Audit Policy has resulted in a significant decrease in accountability, I do not think that the Audit Policy can be opposed on accountability grounds.

b. Inherently Governmental Functions

A second concern over outsourcing is the outsourcing of inherently governmental functions. At first glance, enforcement of regulations may not appear to be an inherently government function.[81] In fact, enforcement of some types of regulations is commonly outsourced. According to a 2007 survey of local governments, approximately 15 percent of those surveyed contract out tax collection, 8 percent contract out public works inspections and enforcement, and 5 percent contract out traffic control and parking enforcement.[82] With respect to the enforcement of environmental regulations, however, it is more difficult to make the case that it is clearly not an inherently governmental function.

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[78] For example, see Heckler v. Chaney, 470 U.S. 821 (1985) which holds that agency decisions not to bring an enforcement action are generally "committed to agency discretion by law" and thus not reviewable by a court under the Administrative Procedures Act.
[79] See Clean Air Act (CAA), 42 U.S.C. 7604 (1994); Clean Water Act (CWA), 33 U.S.C. 1365(a)(1) (1994); Resource Conservation and Recovery Act of 1976 (RCRA), 42 U.S.C. 6972 (1994) (as cited in Freeman, Private Role, n.500). However, the ability to bring private suits is only a partial substitute for what the EPA does because the EPA can refer cases to the DOJ for criminal enforcement.
[80] See Timothy T. Jones, Walter G. Wright, Jr., Mary Ellen Ternes, "Environmental Compliance Audits: The Arkansas Experience Winter," 21 U. Ark. Little Rock L. Rev. 191, 1999, p. 240 (noting that citizen's suits are not bound by the enforcement discretion EPA has articulated in its audit policies).
[81] Obviously, the mere fact that something was once performed by government or is usually performed by government does not mean that it is inherently a governmental function.
[82] International City-County Management Association (ICMA) Profile of Local Government Service Delivery Choices, 2007 available at http://icma.org/en/results/surveying/survey_research/survey_results (last accessed September 29, 2010).

There is general agreement that policy decisions and the making of regulation are inherently governmental.[83] But the regulations themselves are not realized by the act of promulgation; the real consequence of a regulation depends not only on the promulgated language, but also on the implementation and enforcement of that regulation.[84] To the extent that enforcement is central to ultimately determining the import of a regulation[85], enforcement could be seen as an indirect "inherently governmental activity."

Although the Audit Policy does reduce penalties for self-disclosed violations, EPA maintains ultimate discretion as to final penalties, what must be done to remediate the violation, etc. and thus determines the ultimate import of the regulations, even with respect to firms that choose to "turn themselves in".[86] Thus even though parts of the enforcement process have been outsources, EPA does continue to determine the ultimate import of the regulations. Moreover, the Audit Policy plays a limited role in EPA's overall enforcement regime. As noted above, for every self-disclosure of a violation, over 16 federal or state regulatory inspections are conducted.[87] Thus, it is hard to make a case for opposing the Audit Policy based on the outsourcing of an inherently governmental function.

c. Reduced Governmental Capacity

The third issue concerns reduced governmental capacity. Any information or experience is gained during the conduct of an outsourced function will accrue to private parties.[88] Some information or experience may be transferred from the private party to the agency, but it may be difficult or impossible to write contracts to induce complete transmission of information. The Audit Policy is structured in a way that should mitigate this concern, as the process for reporting a self-policed violation ensures that information is transferred to regulators as a condition for receiving a penalty reduction. Moreover, to the extent that

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[83] "We regard it as axiomatic that policy decisions must be made by full-time Government officials clearly responsible to the President and Congress." *Report to the President on Government Contracting for Research and Development*, Executive Office of the President, 1962 cited in Verkuil, Outsourcing p.45, n.160. See also Freeman, Private Role, p. 563 (under both the public interest and civic republican theories of administration, agencies provide acts as "a bulwark against narrow private pressure" and thus are able to make decisions in the public interest).

[84] Freeman, Private Role, p.572 ("rules develop meaning, however, only through the fluid processes of design, implementation, enforcement, and negotiation").

[85] See Freeman, Private Role, p.661 ("Only at the enforcement stage do policy choices made by Congress and interpreted by agencies through regulations translate into substantive requirements.").

[86] Audit Policy, Section II.G.3.

[87] Calculation based on the 1,200 self-disclosures and 20,000 regulatory inspections reported in 2009. See footnote 55, supra.

[88] Some information or experience may be transferred from the private party to the agency, but it is likely to be difficult (and may not be possible) to write contracts to induce complete transmission of information. It will also increase the cost of outsourcing, as transmission of information and experience is not costless.

self-disclosures increase the total number of violations of which EPA is aware, EPA's overall level information will increase. Additionally, the act of self-policing should provide additional information to the regulated entity so that the entity can make changes to its operation. Thus any loss in information to EPA is likely to be small, and there is a reasonable expectation that EPA could actually gain information under self-policing. Finally, regulated entities are likely to gain information that will provide public benefits (through increased environmental performance) to offset any loss in experience to EPA.

d. Corruption

The final concern discussed in Part II was the potential for outsourcing to increase corruption. While that is a valid concern in situations where there is a revolving door between agencies and private entities seeking to obtain agency contracts, the Audit Policy is unlikely to increase the potential for or risks from corruption. Unlike many privatization efforts, the Audit Policy outsources to regulated entities themselves, not to outside contractors. This is not to say that the regulated entities do not have incentives to try to cheat, just that the Audit Policy does not increase incentives for public employees to substitute their own personal interests for the public interest.

## V. Other Federal Self-Policing Regimes

Many federal agencies currently incorporate self-policing into their enforcement programs. While the following section does not provide a complete inventory, it does provide a sense of the venues in which self-policing is currently used, and the range of different policies that exist.[89]

ii. *The Federal Aviation Administration*

The Federal Aviation Administration (FAA) established a voluntary disclosure reporting program (VRDP) in 1990.[90] Under this program FAA will forego legal enforcement action against air carriers, repair stations, and aircraft and aircraft equipment manufacturers who voluntarily disclose violations of FAA requirements for maintenance, flight operations,

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[89] Other authors have also compiled lists of federal self-policing efforts but to my knowledge no other author has analyzed these policies with respect to privatization concerns. See John S. Moot, "Compliance Programs, Penalty Mitigation And The FERC," Energy Law Journal, vol 29:547-575 (2008) for a selective list of policies, and Christopher A. Wray and Robert K. Hur, "Corporate Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice," American Criminal Law Review, vol. 43:1095-1148 (2006) for a more exhaustive list (although the focus is on corporate enforcement not self-policing and thus includes policies that do not include self-policing or self-disclosure).

[90] U.S. Government Accountability Office, "Better Management Controls are Needed to Improve FAA's Safety Enforcement and Compliance Effort," GAO-04-046, July, 2004 [hereinafter GAO FAA]. The current version of the policy is delineated in the FAA's Advisory Circular AC-058B [hereinafter AC-058].

drug and alcohol prevention programs, and security functions that meet the following conditions:[91]

- The violation is disclosed immediately once it is detected and before the agency learns of it by other means;
- The violation was inadvertent;
- The violation does not indicate a lack, or reasonable question, of qualification;
- Immediate action is taken to terminate the conduct that resulted in the violation; and
- The regulated entity has developed or is developing a comprehensive solution to correct the violation that is satisfactory to the FAA.

Voluntary disclosures that meet these criteria receive only a warning or "Letter of Correction" rather than any other type of enforcement action (including civil penalties or certificate suspension).[92] Disclosed violations that meet the above criteria are also protected from public release.[93]

According to a Governmental Accountability Office (GAO) report, over 2,000 self-disclosures are filed annually, relative to approximately 15,000 total enforcement actions.[94] To date there has not been any formal evaluation of the VRDP, so there is no empirical evidence of its effect on overall compliance. However, critics of FAA's enforcement policy believe that the VRDP allows regulated entities to avoid formal enforcement actions[95] and in April of 2008 the House Committee on Transportation and Infrastructure held a hearing on "Critical Lapses in FAA Safety Oversight of Airlines: Abuses of Regulatory 'Partnership Programs'" to determine the extent to which the VRDP and other enforcement programs were circumventing formal enforcement of FAA regulations. The FAA contends that the VRDP program is necessary to increase agency awareness of operational safety issues and that it has helped to identify a number of important areas to focus on such as pilot and controller communications and runway incursions.[96] Thus there may be long-term benefits from the VRDP that cannot be measured easily.

In addition to concerns that the VRDP may not be increasing overall compliance, it also appears to raise more outsourcing concerns than EPA's Audit Policy. With respect to

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[91] See AC-058B, Section 7.B.
[92] Statement of Nicholas A. Sabatini, Associate Administrator for Aviation Safety Before the House Committee on Transportation and Infrastructure on "Critical Lapses in FAA Safety Oversight of Airlines: Abuses of Regulatory 'Partnership Programs'," April 3, 2008.
[93] See AC-058B, Section 13.
[94] See GAO FAA pp.14-15 (annual self-disclosures) and p.12-13 (annual enforcement actions).
[95] See, for example John Hughes, "Northwest's `Systemic' Directives Compliance Lapses Escaped FAA, U.S. Says," Bloomberg News, July 23, 2010 and James Hohmann, "FAA Chief Defends Airlines' Voluntary Self-Policing," The Los Angeles Times, April 18, 2008.
[96] GAO FAA, p.25

transparency and accountability, under the FAA's policy disclosures are explicitly exempted from FOIA queries and thus one could argue that transparency and accountability are significantly reduced by this policy. Additionally, if the VRDP does allow regulated entities to circumvent FAA's formal enforcement program, it would make concerns about outsourcing inherently governmental functions more relevant.

ii. *The Department of Energy, Office of Health, Safety, and Security*

The Department of Energy's (DOE) Office of Health, Safety, and Security has had a self-policing policy since 1993.[97] Contractors who operate DOE's nuclear facilities can receive up to 100% penalty mitigation for self-disclosed violations of nuclear safety, worker safety and health, and classified information security regulations depending on the circumstances under which they self-disclose, the nature of the violations, and the extent to which the violation is corrected.[98] Although the DOE policy does not explicitly require that the disclosure meet specific conditions, the criteria on which the level of penalty reduction echo many of the conditions of EPA's Audit Policy as consideration is given to:

- whether prior opportunities existed to discover the violation;
- the extent to which proper contractor controls should have identified or prevented the violation;
- whether discovery of the violation resulted from a contractor's self-monitoring activity;
- the extent of DOE involvement in discovering the violation or in prompting the contractor to identify the violation;
- the promptness and completeness of any required report
- the appropriateness, timeliness and degree of initiative associated with any corrective action; and
- the comprehensiveness of the corrective action.

A GAO report on overall enforcement from the Office of Health, Safety, and Security found.[99]

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[97] Procedural Rules for DOE Nuclear Activities, General Statement of Enforcement Policy, 10 CFR Chapter III, Subchapter I, Part 820, Subpart g, Appendix A, published August 17, 1993 [hereafter DOE Enforcement Policy]. See section IX.b.3.b, "Pursuant to this enforcement philosophy, DOE will provide substantial incentive for the early self-identification, reporting and prompt correction of problems which constitute, or could lead to, violations of DOE Nuclear Safety Requirements. Thus, application of the adjustment factors set forth below may result in no civil penalty being assessed for violations that are identified, reported, and promptly and effectively corrected by the DOE contractor."

[98] DOE Enforcement Policy, IX.b.4-7 (self policers can receive up to 50 percent civil penalty mitigation for self-identified and reported violations and up to 50 percent mitigation for prompt, comprehensive, and effective corrective actions.)

[99] See "Department of Energy Needs to Strengthen Its Independent Oversight of Nuclear Facilities and Operations." Governmental Accountability Office, November, 2008 GAO-09-61), p.33.

> "The actual number of notices of violations and enforcement letters levied against contractors for violating DOE's nuclear safety requirements has been relatively small compared to the number of self-reported conditions of noncompliance that are entered into the Noncompliance Tracking System. Our analysis shows that voluntary entries into the tracking system have averaged around 220 per year since 1999, and the combined number of notices of violations and enforcement letters averaged about 12 per year during this time period."

Thus DOE's self-policing policy appears to play a much larger role in its overall enforcement program than does EPA's Audit Policy. However, there has not been any formal evaluation or analysis of the effectiveness of this policy in increasing overall compliance.

With respect to outsourcing concerns, as is the case with EPA's Audit Policy, DOE's self-policing policy appears to be a complement to DOE's enforcement policy, not a substitute for it. In terms of accountability, self-disclosures are entered into a DOE database along with other agency discovered violations, although some disclosures may not be serious enough to pass DOE's reporting threshold.[100] However, given the nature of the operations at these facilities, it is not clear whether the public can easily obtain information on disclosures. Of course, this applies to DOE enforcement as well, so it is unlikely that the self-policing actions are much less transparent than government enforcement actions.

iii. *The Occupational Safety and Health Administration*

The Occupational Safety and Health Administration (OSHA) finalized its self-policing policy in 2000.[101] Like EPA's Audit Policy, OSHA chose to implement a policy rather than a formal rule.[102] Under its policy, voluntarily self-disclosed violations that are corrected prior to any OSHA inspection will not receive a citation and those violations that are self-disclosed but cannot be corrected prior to an inspection are eligible for a penalty reduction of up to 25 percent.[103] Like EPA OSHA does not give audit documents privilege, but does state that it will not routinely request audit documents.[104]

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[100] However, contractors are still required to track these noncompliances and make them available to DOE enforcement upon request. See, "Enforcement Process Overview," U.S. Department of Energy, Office of Enforcement, June 2009, available at http://hss.energy.gov/enforce/Final_EPO_June_2009_v4.pdf (last accessed on October 3, 2010).

[101] Final Policy Concerning the Occupational Safety and Health Administration's Treatment of Voluntary Employer Safety and Health Self-Audits, 65 Fed. Reg. 46,498 (July 28, 2000) [hereafter OSHA Final Policy].

[102] OSHA Final Policy, Sections III.5.

[103] OSHA Final Policy, Sections V.C.2 and V.C.4.

[104] OSHA Final Policy, Sections III.3, III.4, and V.C.

One of the key differences between this policy and the Audit Policy is that it does not provide any explicit list of conditions that must be met for immunity or penalty reductions to be given other than that the violations must have been discovered in the course of a systematic, documented, and objective review of the regulated entity.[105] Additionally, the policy provides complete immunity for disclosed violations that are corrected prior to an inspection. Thus it appears to be possible for a regulated entity to commit a violation that provides the entity with some economic benefit, and to pay no penalty at all for such a violation if it is disclosed and corrected prior to an OSHA inspection. Because this policy has never been formally analyzed or evaluated, one can only speculate as to its effect on overall compliance.[106] However, the two differences with the Audit Policy cited above are both differences that are likely to have a negative effect on compliance. Theoretical models of self-compliance have noted that providing complete immunity – particularly not requiring entities to pay a penalty equivalent to the economic benefit they received from the violation – can lead to higher violations. Also, as noted in Section IV.ii, state environmental self-policing policies that provided complete immunity have be shown to result in lower levels of compliance and environmental performance. [107]

The OSHA policy also raises some outsourcing concerns. With respect to accountability, the policy makes no provision for making acts of self-policing public. Another concern is that OSHA enforcement and penalties are generally acknowledged to be relatively meager – certainly not at the same level as EPA enforcement and penalties.[108] Thus, it is not clear that self-policing is used to complement OSHA enforcement rather than be a substitute for it, making concerns that an inherently government function is being outsourced more pertinent.

iv. *Federal Electric Regulatory Commission*

The Federal Electric Regulatory Commission (FERC) incorporated self-policing into its enforcement program for electricity transmission and wholesale sales markets from the program's inception in 2005.[109] Under FERC's self-policing policy, the fact that a facility

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[105] See generally OSHA Final Policy. This requirement that the discovery be the result of a systematic, objective review is very similar to condition 1 of EPA's Audit Policy (see Audit Policy, Section II.D (19,625-19,626).

[106] The GAO conducted a study on OSHA's voluntary compliance programs which include the self-policing policy, but the self-policing policy was not separately identified in the report, nor was there any formal evaluation of the effectiveness of the voluntary compliance (see "OSHA's Voluntary Compliance Strategies Show Promising Results, but Should Be Fully Evaluated before They Are Expanded", Governmental Accountability Office, March, 2004 GAO-04-378).

[107] See Stafford, Does Self-Policing Help and Guerrero and Innes, Statutory Rewards.

[108] See "OSHA Plans to Launch New Penalty Policy With Higher Fines This Fall, Barab Says," Occupational Health and Safety Reporter, September 16, 2010, BNA, available at http://ehscenter.bna.com/PIC2/ehs.nsf/id/BNAP-89CETL (last accessed October 3, 2010).

[109] The 2005 Energy Policy Act gave FERC new civil penalty authority, Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005). To implement this authority, FERC adopted

self-reports can result in up to 100 percent penalty mitigation.[110] Like DOE's policy, FERC does not explicitly require that the disclosure meet specific conditions, but does say that the level of mitigation depends on:[111]

- The manner in which the violation was discovered;
- The timeliness with which the violation was disclosed; and
- Steps taken to stop or correct the violation.

FERC provides overall statistics about the number and types of self-disclosures made from 2006-2009, as well as the disposition of those self-disclosures in its 2009 Enforcement Report, but there has not been an analysis of the effectiveness of the self-policing program.[112] FERC's self-policing policy plays a more significant role in overall enforcement that EPA's policy does. For example, in 2009, there were 122 self-disclosures compared to only 10 investigations and 33 audits by public officials.[113]

Unlike EPA's policy, there is no statement in FERC's self-policing policy that self-disclosures will be made available to the public. On the contrary, FERC's enforcement report states

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a new enforcement regime which implied that self-policing would be a mitigating factor in determining penalties (see Enforcement of Statutes, Orders, Rules, and Regulations, 113 FERC 61068 (2005) "In discussing the factors we will take into account in determining the severity of penalties to be imposed for violations, we also recognize the importance of demonstrable compliance and cooperation efforts by utilities, natural gas companies, and other entities subject to the statutes, orders, rules, and regulations administered by the Commission. We encourage regulated entities to have comprehensive compliance programs, to develop a culture of compliance within their organizations, and to self-report and cooperate with the Commission in the event violations occur.") In 2008 FERC reiterated its commitment to reducing penalties for self-disclosed violations (see, Revised Policy Statement On Enforcement, 123 FERC 61,156 (2008) pp.24-25 [hereinafter FERC, Revised Statement]).

[110] See FERC, Revised Statement, Section III.B.3.d.iii, "In most cases, self- reported violations have resulted in the matters being closed without any enforcement action being taken. In the cases where a self-report did result in enforcement action, the penalties reflected mitigation credit for the self-reporting. While we do not articulate here the precise amount of mitigation credit that was earned for self-reporting in our recent enforcement actions, we reiterate that the penalties in these cases would have been greater absent self-reporting."

[111] FERC, Revised Statement, Section III.B.3.d.iii.

[112] FERC's 2009 Report on Enforcement (Docket No. AD07-13-002, December 17, 2009) [hereinafter FERC 2009 Report of Enforcement] enumerates the number and types of self-disclosures made from 2006-2009, as well as the disposition of those self-disclosures, but does not attempt to analyze the effectiveness of the self-policing program.

[113] FERC 2009 Report of Enforcement, p. 8 (2009 self-reports), p. 14 (2009 investigations) and p. 20 (2009 regulatory audit statistics). 2009 did represent an increase in self-reports over earlier years, but data on investigations and regulatory audits in earlier years was not provided.

that much of the enforcement actions the agency takes are "non-public Enforcement activities, such as self-reported violations and investigations that are closed without any public enforcement action or civil penalty assessments."[114]

Since both FERC enforcement and the self-policing policy are relatively new phenomena, it is hard to assess whether this instance of outsourcing is beneficial or not. On the one hand, the policy does seem to follow EPA's and DOE's policies in many important respects, not providing blanket immunity but rather conditioning disclosures. However, the conditions are very vaguely expressed and there is no formal mechanism for reporting self-disclosures to the public, raising some outsourcing concerns.

*v. Department of Justice, Antitrust Division*

Since 1993, The Department of Justice's Antitrust Division has had a formal Corporate Leniency Program which accords "leniency" to corporations that report their own illegal antitrust activity at an early stage, if the self-disclosure meets certain conditions:[115]

- The self-disclosure occurs before DOJ has begun an investigation;
- DOJ has not received information about the illegal activity being reported from any other source;
- The corporation did not coerce another party to and was not the leader in, or originator of, the activity;
- After discovering the illegal activity, the corporation "took prompt and effective action" to terminate its part in the activity;
- The illegal activity is reported candidly and completely and the corporation provides full cooperation throughout the investigation;
- The disclosure is made by the corporation, not individual executives or officials; and
- Where possible, the corporation makes restitution to injured parties.

If the first three conditions are not, but the self-disclosure meets the remaining conditions as well as the following conditions, it will also receive leniency:[116]

- The corporation is the first to come forward and qualify for leniency with respect to the illegal activity being reported;

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[114] FERC 2009 Report of Enforcement, p. 1.

[115] Department of Justice Antitrust Division, Corporate Leniency Policy, August 10, 1993 [hereinafter DOJ Corporate Leniency Policy] available at http://www.justice.gov/atr/public/guidelines/0091.pdf. The Antitrust Division had an Amnesty Program as early as 1978, but amnesty was not granted automatically and the program had flaws which led to very few applications and ultimately no cases (see Scott D. Hammond, "Detecting And Deterring Cartel Activity Through An Effective Leniency Program" presented at the International Workshop on Cartels, Brighton England, November 21-22, 2000 available at http://www.justice.gov/atr/public/speeches/9928.htm.)

[116] DOJ Corporate Leniency Policy.

- DOJ does not yet have evidence against the company that is likely to result in a sustainable conviction; and
- DOJ determines that granting leniency would not be unfair to others, considering the nature of the illegal activity, the confessing corporation's role in it, and when the corporation comes forward.

If the self-disclosure meets either set of conditions, DOJ will not charge the corporation criminally for the activity being reported and, since 2004, self-disclosing corporations will only be subject to restitution of damages, not treble damages.[117] DOJ also has an individual leniency policy that has analogous conditions for individuals self-disclosing illegal activity where the corporation does not come forward.[118] Of course, this policy is quite different from the other self-policing policies discussed in this paper and the theoretical models discussed in Part III because the violations of law involve conspiracies between multiple entities. The fact that only the one entity can receive leniency changes the incentives for entities to participate. However, it is still a self-policing policy and it does provide additional insight into the aspects of various policies that might make outsourcing concerns more or less important.

One characteristic of the policy is that leniency requires restitution to injured parties – thus like EPA's policy it is only the "punitive" penalties are forgiven and thus in theory self-policers should not receive any economic benefit from their illegal activity.[119] While there have not been any empirical studies of the effect of the policy on cartel formation or cartel collapse, because of the difficulty in enforcing antitrust laws, the Corporate Leniency Program plays a very important role in the overall enforcement program.[120] In 2003 the Antitrust Division received over one disclosure a month and "the majority of the Division's major international investigations [were] advanced through the cooperation of an amnesty applicant."[121] Since the policy allows DOJ to prosecute other anti-trust violators, it clearly acts as a complement to its enforcement programs rather than as a substitute.

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[117] See, Antitrust Criminal Penalty Enforcement and Reform Act of 2004, Public Law 108-237, Title II

[118] Department of Justice Antitrust Division, Leniency Policy for Individuals, August 10, http://www.justice.gov/atr/public/guidelines/0092.pdf.

[119] Although companies may be eligible for partial amnesty from penalties in other cases, see Gary R. Spratling, "Making Companies an Offer They Can't Refuse: The Antitrust Division's Corporate Leniency Policy -- An Update," Presented at the Bar Association of the District of Columbia's 35th Annual Symposium on Associations and Antitrust, February 16, 1999 available at http://www.justice.gov/atr/public/speeches/2247.htm.

[120] See Joseph E. Harrington, "Optimal Corporate Leniency Programs," *The Journal Of Industrial Economics*, V. LVI, No. 2, pp.217-246, 2008 ("While it is difficult to assess the role of the leniency program on causing cartels to collapse or deterring cartels from forming, we do know that it has been widely used.")

[121] See James M. Griffin, "The Modern Leniency Program After Ten Years: A Summary Overview Of The Antitrust Division's Criminal Enforcement Program," presented at the

The only outsourcing concern that one might have with respect to the Corporate Leniency Program is that, unlike the Audit Policy, the identity of self-policers under the is not normally made publicly available.[122]

## VI. Principles to Guide Self-Policing Policies

As should be clear from the sample of self-policing policies discussed in the previous sections, there is a wide variation in both the design and implementation of such policies. As discussed in Section II, for a self-policing program to be a justifiable delegation of a public function to private parties it must first increase overall efficiency – that is it must either increase compliance or maintain existing compliance levels at reduced cost. If a policy can be designed to increase efficiency, it should then be evaluated with respect to the outsourcing concerns discussed in this paper.

With regard to the first condition, ideally agencies would use formal evaluations and analysis to ensure that -- at a minimum -- compliance does not decrease under the self-policing program. Additionally, the program should be constructed initially so that it does not provide perverse incentives for regulated entities to decrease compliance efforts and it minimizes the ability of firms to strategically self-disclose. While the particular details of each policy will obviously vary from program to program, one underlying principle is that there must be some positive chance that regulated entities will be subject to regulatory inspection and prosecution for detected violations. If entities that self-police face no or only a very small (approaching zero) probability of inspection, then in practice there is no enforcement. Not only could this undermine respect for the law, it provides regulated entities with the opportunity to strategically self-police in order to reduce future enforcement to zero and then cease to make any effort to comply, thereby increasing the number of undetected violations.[123]

Additionally, given that several analyses of the Audit Policy suggests that complete penalty immunity worsens overall compliance levels and no studies suggest any beneficial result of complete immunity, I do not think self-policing policies should confer complete immunity. At a minimum, self-policers should always have to pay a fine equal to any economic benefit received by violations – otherwise they are better off violating and self-policing rather than complying. Unfortunately, not all existing Audit Policies make the distinction between punitive fines and those related to the economic benefit of non-compliance.

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American Bar Association Section Of Antitrust Law Annual Meeting, August 12, 2003, available at http://www.justice.gov/atr/public/speeches/201477.htm.

[122] See John M. Connor, "Anti-Cartel Enforcement by the DOJ: An Appraisal," The Competition law Review, V.5, No.1, p. 96.

[123] This does not preclude an agency from rewarding self-policers with reduced future inspection relative to non-policers, although it might require raising the base inspection rate.

Self-policing policies should also be designed to minimize outsourcing concerns. With respect to accountability, the concept of self-policing does not require that accountability or transparency be sacrificed. Any decrease in accountability is a result of a policy design or execution choice made by the regulatory agency, and does not appear to be necessary to achieve efficiency. Of course, enforcement is an area in which accountability is limited from the start and most agencies exercise significant discretion in deploying their enforcement resources and determining the punishment for entities found in violation. Thus I would propose two guidelines to ensure that accountability is not significantly decreased by self-policing: first, all self-disclosures should be made publicly available, preferably in the same way that other enforcement data is provided to the public; second, any right to bring private action against regulated entities should be protected.

To ensure that self-policing does not become an inherently governmental function, under any self-policing policy public officials should retain ultimate discretion in setting final penalties and determining how violations are to be remediated. Additionally, self-policing should never be the sole means of enforcement – not only because all existing theoretical models of self-policing require a public enforcement mechanism to make the policy work, but also because doing so ensures that regulated entities do not determine the ultimate import of regulations. Thus as a guideline for developing self-policing programs, I would require that they be used to supplement public enforcement regimes, and should not be used as substitutes for traditional enforcement.

Finally, to ensure that the is no significant loss of information to government officials as a result of self-policing, self-policing policies should require, as EPA's policy does, that entities provide detailed information as to the nature of the discovered violations.

While these guidelines may seem to be simple or obvious principles, they have not been universally adopted in all existing self-policing policies. Of course, adoption of these principles alone will not ensure that all self-policing is ultimately justifiable. Thus I also advocate empirical analyses of all self-policing policies to assess the relative efficiency gains and outsourcing concerns.

In conclusion, as I hope my paper demonstrates, self-policing is neither uniformly beneficial, nor uniformly dangerous. The potential benefits from self-policing are large and while the concerns over outsourcing are real, there are ways to minimizing many of the concerns that might lead some to resist outsourcing. Hopefully there will be no need to trade principles of good government against the efficiency if we appropriately design self-policing policies.