

Performance-Based Regulation and Regulatory Regimes

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ABSTRACT

The notion that regulations should be based on achievement of specified results rather than on adherence to particular technologies or prescribed means has been widely accepted as a basis for improving social and environmental regulation. This paper considers aspects of performance-based regulation with particular attention to the expectations for performance-based regulatory regimes.

Regardless of the form that performance-based regulation takes, it cannot be considered as separate from the broader regulatory system. The appeal of performance-based regulation is as much about introduction of a new regulatory regime as it is about regulating for results. The broad expectations are that performance-based regulations will reduce regulatory rigidity and compliance burdens while promoting innovation and allowing for lower compliance costs. How these play out and the other consequences of performance-based regulatory regimes are hard to specify in the abstract as they depend on the specifics of the regulatory design and how it is implemented.

Any regulatory regime entails finding a balance between how tight controls should be in promoting consistency and accountability versus how much discretion should be granted in promoting flexibility and innovation. The prescriptive approach emphasizes control and accountability. The performance-based approach desires to promote flexibility with accountability for results. Accountability is a fundamental and thorny issue for performance-based regulations. The performance-based regulatory regime is subject to a potential global capture if performance accountability is determined by regulated entities or proxies for them.

Performance-Based Regulation and Regulatory Regimes

The notion that regulations should be based on achievement of specified results rather than on adherence to particular technologies or prescribed means has been widely accepted as a basis for improving social and environmental regulation. The concept of performance-based regulation has been endorsed by the Bush and Clinton administrations, by a variety of business and environmental groups providing consensus proposals for reform of environmental regulations, and by various groups recommending regulatory reforms in other areas of regulation. Variants of performance-based regulation have been adopted in the United States as well as a number of other countries for regulation of aspects of air and water quality, building and fire safety, consumer product safety, energy efficiency, food safety, forest practices, nuclear power plants, pipeline safety, and worker safety.

To be sure, performance-based regulation has not fully supplanted more traditional forms of protective regulation. Many regulations in the United States are still highly prescriptive in telling regulated entities what to do and how to do it. And, when the performance-based approach is offered, it is usually simply presented as an alternative to existing prescriptive regulation. Despite the enthusiasm for results-based regulation in governmental circles, the merits and feasibility of the approach are open to debate (see Coglianesi & Lazar 2002, Coglianesi, Nash, & Olmstead 2002, Office of Technology Assessment 1995, Steinzor 2001). This paper contributes to this debate by discussing the implications for regulatory regimes.

What constitutes performance-based regulation is complicated by the fact that the concept can be, and has been, applied in a variety of ways and with different degrees of regulatory comprehensiveness. Regardless of the form that it takes, performance-based regulation cannot be considered as separate from the broader regulatory system. Indeed, the appeal of performance-based regulation is as much about introduction of a new regulatory regime as it is about regulating for results. As such, understanding performance-based regulation requires thinking about expectations for regulatory regimes.

Any regulatory regime must confront a fundamental issue of how tight controls should be in promoting consistency and accountability versus how much discretion should be granted in promoting flexibility and innovation. As discussed in what follows, the performance-based approach to regulation moves this balance from promoting consistency and accountability under current prescriptive approaches toward greater emphasis on flexibility and innovation. At issue for any particular regulatory situation is how that balance is being struck.

REGULATORY BENEFITS AND BURDENS

Regulations are aimed at preventing harms or providing benefits for segments of society. Potential harms include such things as threats to public health, safety, welfare, the environment, or well-being. Potential benefits from regulations include such things as provision of open space, access to coastal areas, and the provision of affordable housing. Of interest here are those regulations that prevent harms and that have generally been labeled protective regulations (see Bardach & Kagan 1982).

There are four key elements to any protective regulation: (1) rules that govern expected behaviors or outcomes, (2) standards that serve as benchmarks for compliance, (3) sanctions for non-compliance with the rules, and (4) an administrative apparatus that enforces the rules and administers sanctions. These four elements constitute what might be deemed the structural

elements of a regulatory regime.¹ By altering any of these elements, the nature of the regime can be changed. For example, a highly-prescriptive regulation specifies particular materials to be used and particular grades of the material that are acceptable for different conditions. A performance-based regulation specifies a threshold of acceptable performance and a means for verifying that the threshold has been met. Management-based regulatory approaches address a mandated process that can be either highly prescribed or defined in terms of desired outcomes of that process (see Coglianese and Lazar 2002).

For any regulatory approach a variety of practical issues must also be considered. These concern the frequency and nature of reviews and inspections, the style of interaction of inspectors and regulated entities, the way in which sanctions are used, and the willingness of regulators to accept alternative approaches to accomplishing the same end. Although these issues are seemingly mundane in comparison to the bigger issues of regulatory reform, they are essential aspects of regulatory practice. Sparrow discusses these aspects in commenting about the craft of regulation: “[t]he nature and quality of regulatory practice hinges on which laws regulators choose to enforce, and when; on how they focus their efforts and structure their use of discretion; on their choice of methods for procuring compliance. Yet the vogue prescriptions for the reinvention or reform of government, which have been swirling around regulatory executives for close to ten years, say little about these issues and sometimes ignore them altogether” (2000: 2).

Thinking about regulatory regimes as comprised of a structural framework and a set of implementation actions helps to put into perspective criticisms of unreasonable regulation. One line of attack has been the rules and standards themselves that are within the basic regulatory structure. These criticisms have been popularized in Philip Howard’s book The Death of Common Sense (1994). These critics argue that many rules and standards are unreasonable, narrowly defined, and overly prescriptive. A second related line of attack on unreasonable regulations addresses the way that the front lines of regulatory agencies enforce regulations. As noted by Bardach and Kagan: “Site-level unreasonableness explains much of the present political and social discontent with protective regulation...[T]he present discontent with protective regulation, as expressed in most complaints about it, has almost nothing to do with aggregate costs and almost everything to do with particular costs and aggravations imposed by particular enforcement officials on particular institutions and businesses” (1982: 7).

Critics argue that unreasonable regulations and capricious enforcement practices impose unneeded burdens on regulated entities. For example, the National Association of Homebuilders found in a 1998 survey of association members that 10 percent of the cost of building a typical new home are attributable to unnecessary regulation, regulatory delays, and fees (U.S. House Committee on Small Business 2000: 42). Critics also argue that the inflexibility of prescriptive regulations limit innovation (Oster & Quigley 1977) or constrain international competitiveness (Porter & van der Linde 1995). Key themes for those regulatory reform are reducing these burdens and promoting innovative solutions. Regulatory relief became a major initiative in the United States beginning in the early 1980s under actions taken by the Reagan administration to roll back regulations. This push evolved over time, and with different presidential administrations, to later emphasis by the Clinton administration on “common sense” regulation. Within the context of these reforms, performance-based regulation can be viewed as another step in regulatory reform.

¹ This discussion of regulatory structure draws from May (2002). For discussion of the concept of regulatory regimes more generally see Hood et al. (2001). Regulatory regimes involving third-party or industry-developed codes of practice that entail voluntary participation by firms in adhering to those codes are not considered within this framework (see Potaski and Prakash 2002).

EXPECTATIONS FOR PERFORMANCE-BASED REGIMES

Any reform is at least in part a reaction to perceived failures of what preceded it. As such, the expectations for performance-based regulatory regimes are shaped as much by prior shortcomings as they are by conceptualizations of what constitutes “good” regulation. With this in mind, it is useful to consider performance-based approaches to regulation as a reaction to the perceptions of overly rigid rules and inflexible enforcement. As discussed above, critics argue that these regulatory shortcomings impose unnecessary burdens and limit innovation.

Performance-based regulations are part of the more general trend in regulatory reform, beginning with the Reagan administration in the early 1980s, to lessen rigidity and compliance burdens while promoting innovation and allowing for lower compliance costs. One statement of the multiple objectives of regulatory reform is contained in the principles of regulation set forth in Executive Order 12866, the primary federal regulatory planning and review directive adopted by the Clinton administration and subsequently reaffirmed by the Bush administration. Federal agencies are directed to take into account in regulatory design the need for and effectiveness of regulations along with “incentives for innovation, consistency, predictability, the costs of enforcement and compliance (to the government, regulated entities, and the public), flexibility, distributive impacts, and equity” (section (b)(5)). A more precise statement of expectations for performance-based approaches is contained in the Clinton administration’s strategy for reinventing environmental regulation in stating as a key principle that “[e]nvironmental regulations must be performance-based, providing maximum flexibility in the means of achieving our environmental goals, but requiring accountability for results” (National Performance Review 1995: 6).

Two realities must be recognized regarding such statements about regulatory objectives. One is the obvious incompatibilities of the differing objectives. Among other conflicts, the objectives of consistency, equity, and predictability are at odds—or at least in tension—with the objectives of flexibility and innovation. Similarly, there is a basic tension between flexibility and accountability. Accountability requires an ability to observe outcomes, while flexibility frustrates that ability by permitting a variety of ways of achieving outcomes. Underlying these potential conflicts is a fundamental tensions between discretion and control that regulatory authorities must confront when carrying out regulations. This tension is aptly summarized by Sparrow who comments:

Some say that the answer to regulatory unreasonableness is to give regulators more discretion. Others say that the regulators themselves are the problem and that the solution is to take away their discretion by exerting tighter legislative control. The dilemma is familiar and ages old. Too little discretion provides legalistic, nitpicky behavior and denies regulators the means to tailor their responses to local or particular circumstances. Too much discretion creates opportunities for corruption and discrimination and opens a regulatory agency to capture by the regulated community. (2000: 238)

Under performance-based regulation, the pendulum is clearly swinging away from tight controls and toward increased discretion and flexibility.

A second reality, also reflected in Sparrow’s remarks, is that the design of a regulation is only part of the equation. While a regulation may be designed to promote innovation, encourage flexibility, or minimize compliance costs, the reality of that regulation rests on what regulatory agents do in the field when enforcing the regulation and monitoring performance (also see Bardach & Kagan 1982: 34-35). Here is where the potential for inequities and inconsistencies arise and where regulated entities form their impressions about a given set of regulations. Here, as well, the informal aspects of law as played out with the style of interactions between regulators

and regulatees become paramount. These shape the trust that regulated entities place in regulators, the legitimacy that regulated entities attach to regulations, and ultimately the acceptance and adherence to regulations by regulated entities (see Tyler 1990, 1994; Winter & May 2001). As found by May and Wood (2003) in studying homebuilders, regulated entities will react negatively to the lack of predictability if performance-based regulations are inconsistently interpreted. Similarly, regulated entities will see little improvement over the prior more prescriptive regulations if performance-based regulations are interpreted too narrowly in allowing for a limited range of solutions.

Table 1 summarizes what the literature suggests about performance-based regulatory regimes relative to more prescriptive approaches. The potential benefits are greater effectiveness in reaching specific regulatory objectives, flexibility in means of adhering to the regulation, increased incentives for innovation, and reduced costs of compliance for regulated entities. The potential drawbacks are inconsistencies in application of rules, decreased predictability in regulatory expectations, increased costs to governmental regulators, and uncertain equity and distributive impacts. Many of these expectations have been framed in the literature in very general terms. Given the caveats that apply in generalizing from this literature, it is perhaps best to think of the entries in Table 1 as a set of hypotheses about expected effects.

Three sets of uncertainties stand out in Table 1. One is the cost to government of developing and enforcing performance-based regulations. Gunningham and Johnstone (1999: 28) suggest performance-based regulations are less costly to develop because they do not require detailed understandings of relevant technologies but may be more costly to enforce because of the vagueness of performance standards and lack of expertise on the part of enforcers. The Office of Technology Assessment (1995: 43) argues that it can be costly, and sometimes prohibitively so, to develop accurate monitoring technology for gauging performance. Ironically, a second uncertainty stems from the fact that none of the studies reviewed address the costs to public beneficiaries of performance-based regulations.² The presumption is that public benefits accrue from greater effectiveness in reaching regulatory objectives and productivity gains by regulated entities. The potential for increased governmental costs also implies potential increased costs to the public. A third uncertainty is the potential inequities derived from some firms having greater abilities to take advantage of alternative approaches than others leading to competitive differences. Whether this constitutes a legitimate harm to other firms is, of course, a normative matter for which arguments can be made on both sides.

The bottom line for this discussion of expectations is that some aspects—increased flexibility and potential for reduced compliance costs by firms—are relatively predictable while many others depend on the specifics of the design and implementation of the performance-based regulatory regime. Figuring this out, therefore, requires attention to specific applications of performance-based regulatory regimes.

² The OMB regulatory guidance under Executive Order 12866 suggests that if regulations are to be adopted as justified by benefit-cost analyses, performance-based regulations are generally preferred (U.S. Office of Management and Budget 2003). Coglianese and Lazur (2002: 17) argue that performance-based regulation is generally preferable over technology and management-based approaches when there is adequate capacity to assess firm outputs and when firms differ greatly in their size and operations.

Table 1. Expectations for Performance-Based Regulatory Regimes

Criterion	Expectation ^a
<ul style="list-style-type: none"> • <i>Effectiveness</i> in reaching regulatory objectives 	<ul style="list-style-type: none"> • <i>Increased</i>, but limited incentive to go beyond minimum performance objectives (Coglianese and Lazar 2002, Gunningham and Johnstone 1999).
<ul style="list-style-type: none"> • <i>Flexibility</i> in means of adhering to regulation 	<ul style="list-style-type: none"> • <i>Increased</i>, given ability to use alternate means to reach objectives (US Regulatory Council 1981 among many others).
<ul style="list-style-type: none"> • <i>Innovation</i> potential 	<ul style="list-style-type: none"> • <i>Increased</i> incentives for innovation, but depends on industry structure and cost of innovation compared with current approaches (Office of Technology Assessment 1995).
<ul style="list-style-type: none"> • <i>Consistency</i> in application of rules 	<ul style="list-style-type: none"> • <i>Potential for inconsistencies</i> in interpretation of what is acceptable for which the standards and skills of inspectors are important (Gunningham and Johnstone 1999).
<ul style="list-style-type: none"> • <i>Predictability</i> in regulatory expectations 	<ul style="list-style-type: none"> • <i>May decrease</i> due to lack of understanding of what is a workable means for achieving desired ends; code of practice guidelines are useful in this respect (Foliente 2000, Gunningham and Johnstone 1999).
<ul style="list-style-type: none"> • <i>Cost</i> to: <ul style="list-style-type: none"> • <i>Government regulators</i> 	<ul style="list-style-type: none"> • <i>Uncertain</i> -- Greater costs of developing rules and enforcement (Office of Technology Assessment 1995, US Regulatory Council 1981), but not necessarily so for costs of developing rules (Gunningham and Johnstone 1999).
<ul style="list-style-type: none"> <ul style="list-style-type: none"> • <i>Regulated entities</i> 	<ul style="list-style-type: none"> • <i>Decreased or no change</i> in compliance costs (US Regulatory Council 1981), but some entities may choose to develop more costly alternative approaches (Coglianese, Nash, Olmstead 2002).
<ul style="list-style-type: none"> <ul style="list-style-type: none"> • <i>Public beneficiaries of regulation</i> 	<ul style="list-style-type: none"> • <i>Decreased or no change</i> – not explicitly addressed in the literature; presumably benefit from lower costs to regulated entities and innovations spurred by performance-based approach.
<ul style="list-style-type: none"> • <i>Distributive impacts</i> in addressing regulated harms 	<ul style="list-style-type: none"> • <i>Mixed</i> – Focuses attention on a given harm no matter where it is, but leaves potential for gaps in coverage of attention to that harm if performance is gauged on an area-wide basis through “hot spots” (Office of Technology Assessment 1995)
<ul style="list-style-type: none"> • <i>Equity</i> in treatment of regulated entities 	<ul style="list-style-type: none"> • <i>Uncertain</i> -- Competitive differences may emerge due to large firms having advantage in developing alternative approaches (US Regulatory Council 1981) for heterogeneous industry. How rules are enforced will also affect equity.

Notes:

^a Expectations provided by sources noted in parentheses about performance-based regulation when compared to prescriptive-based regulatory approaches.

CHALLENGES FOR REGULATORY REGIMES

Any regulatory regime must confront a fundamental issue of how tight controls should be in promoting consistency and accountability versus how much discretion should be granted in promoting flexibility and innovation. The prescriptive approach emphasizes control and accountability. The performance-based approach desires to promote flexibility with accountability for results. But, obtaining the latter can be problematic.

One example of such problems is the experience with performance-based building regulation in New Zealand and what became known as the “leaky building crisis.” Problems under the performance-based New Zealand Building Act with certification of alternative building methods and with third-party certification of buildings contributed to widespread problems with the weather-tightness of buildings. The symptoms were most apparent for condominiums built with monolithic cladding panels and for high-priced residences built with similar types of synthetic stucco sheathing. The extent of the problem is unknown with various reports and newspaper coverage suggesting up to 18,000 homes and numerous multi-unit buildings being affected particularly in the Auckland area. Given that similar problems with weather-tightness have arisen under more prescriptive regimes in Vancouver, parts of the United States, and other settings, the saga of leaky buildings in New Zealand cannot be judged as an indictment of performance-based regulation per se.

Rather, the New Zealand case illustrates problems with a leaky regulatory regime. The regulatory approach allowed for flexibility without adequate accountability. In particular, the regulatory regime placed too much faith on self-correction of the marketplace as a means of control and too little emphasis on accountability for results. As stated by one of the reviews of the leaky building crisis: “the [Building] Act is very much the product of its time and the *laissez faire* philosophy that prevailed in the 1980s and early 1990s. Opinions on light-handed regulation, the concept on which the Act is based, have changed. There is now a greater consciousness of the need to manage the balance between flexibility and intervention” (Hunn Report 2002: 4).

Accountability is a fundamental and thorny issue for performance-based regulations and as such is the Achilles heel of this form of regulation (more generally see Behn 2001). Prescriptive-based regulatory programs attempt to achieve accountability by mandating adherence to the rules and are biased towards monitoring adherence to rules that are easy to observe. As a consequence, accountability under such systems can be haphazard and misplaced with little attention to the end result (Bardach and Kagan 1982, Sparrow 2000). Performance-based approaches seek accountability for results, but observing or predicting results can be costly or even infeasible. In the New Zealand case, the problem was less a question of feasibility and more one of not wanting to invest the necessary resources given the twin desires to reduce the scope of government and to lessen enforcement burdens for regulated entities. These forces contributed to over-reliance on poorly trained third-party certifiers and to lax review of alternative building products. In short, there was a naïve faith that “the market” would help correct deficiencies in building practices.

The issue of accountability is closely related to the traditional regulatory concern about potential for regulatory capture. As discussed by Wilson (1980), regulatory capture refers to situations for which regulations benefit particular private interests rather than provide the broader public benefit that the regulations are intended to promote. Prescriptive regulatory provisions are open to forms of localized capture by promoting particular products or technologies and to a more global form of capture if regulated entities gain from exclusionary practices. There is debate in the regulatory literature about these with a general consensus that the more global forms of capture are largely elements of the past. The classic examples are the regulation of railroad and trucking industries (see Robyn 1987). The local forms of regulatory have lesser consequences,

but can lead to the type of inefficiencies and burdens that are the focal points of criticisms of prescriptive regulations.

The performance-based approach to regulation avoids the localized form of capture by not prescribing particular methods or materials. As a consequence, particular producers of prescribed materials or methods are not favored over others or at the expense of the public interest. Indeed, performance-based regulation is aimed at promoting competition to provide better and more cost-effective ways of complying with regulations. However, the New Zealand case suggests how a performance-based regulatory regime can be subject to the more global form of regulatory capture. At issue is how accountability for performance is determined. In the New Zealand case, de facto standards for performance of cladding systems were established by the marketplace with those standards falling short of what was intended by the performance-based code. This could be characterized as a form of global capture in that the public interest was not well served and some in the building industry gained in the process, at least in the short term, by having inexpensive construction methods. Stated differently, the issues of regulatory capture do not necessarily disappear under a performance-based regulatory regime. They simply appear in more subtle forms.

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