



# A generalized model for reputational sanctions and the (ir)relevance of the interactions between legal and reputational sanctions

Murat C. Mungan<sup>a,b,\*</sup>

<sup>a</sup> Florida State University College of Law, United States

<sup>b</sup> Florida State University, Department of Economics, United States



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## ABSTRACT

Reputational sanctions and stigmatization costs share many things in common. In particular, wage reductions in the labor market caused by stigmatization (Rasmusen, 1996), and profit reductions in commercial markets caused by reputational losses due to a firm's previous wrong-doings (Iacobucci, 2014) share many similarities. In this article, I construct a model in which Rasmusen (1996) and Iacobucci (2014) emerge as special cases. I use this model to show that increasing the legal sanction (or the probability of detection) cannot cause a reduction in reputational losses that off-sets the increase in expected total sanction. This clarifies ambiguities in the previous literature, and implies that, absent further considerations, deterrence is enhanced by an increase in legal sanctions and/or the probability of detection. Thus, standard Beckerian dynamics are preserved even when reputational sanctions interact with formal sanctions.

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## 1. Introduction

A host of sanctions have been considered in the economics of law enforcement literature, including, extralegal sanctions<sup>1</sup>; stigma<sup>2</sup>; reputational sanctions<sup>3</sup>; sanctions by social norms<sup>4</sup>; informal sanctions<sup>5</sup>; and nonlegal sanctions.<sup>6</sup> A commonality among these sanctions is that they are incurred in addition to the primary legal sanction associated with the act. These terms are often used vaguely and interchangeably. In contrast to this general tendency, Iacobucci (2014) provides an exceptionally precise definition of the term 'reputational sanctions'<sup>7</sup>:

*[A] reputational sanction arises because of the observer's pure self-interest, not a self-interest derived from wanting to adhere to a social norm or avoid punishment from others. The reputational sanction arises because observers have changed their views about the benefits of dealing with a wrongdoer that has revealed by its*

*wrong its type as one that is unattractive to trading partners (with "trading" conceived broadly).*

Using this definition,<sup>8</sup> Iacobucci points out that the severity of legal sanctions can interact with reputational sanctions: legal sanctions affect the number and distribution of wrong-doers and law-abiders, and thereby provide relevant information regarding the difference in the characteristics of average wrong-doers and law-abiders, such as their propensity to break the law, which may be negatively correlated with their productivity. An increase in formal sanctions may cause fewer people to offend in equilibrium, thus increasing both wrong-doers' and law-abiders' average propensities to commit an offense. Therefore, such increases can reduce reputational sanctions, if wrong-doers' average propensity is increased less than law-abider's average propensity to commit an offense.

Two major claims are made in this study, which reveals that there is a need (i) to bridge the gap between the research on reputational costs in the market and the research on stigmatization, and (ii) to clarify an ambiguity regarding the nature of the interactions between expected formal sanctions and informal sanctions.

\* Correspondence to: Florida State University College of Law, 425 W. Jefferson St., Tallahassee, FL 32301, USA.

E-mail addresses: [mmungan@law.fsu.edu](mailto:mmungan@law.fsu.edu), [mmungan@gmu.edu](mailto:mmungan@gmu.edu)

<sup>1</sup> Bar-Gill and Harel (2001).

<sup>2</sup> Harel and Klement (2007), Rasmusen (1996).

<sup>3</sup> Iacobucci (2014).

<sup>4</sup> Zasu (2007).

<sup>5</sup> Zasu (2007) and Iacobucci (2014).

<sup>6</sup> Iacobucci (2014).

<sup>7</sup> Iacobucci (2014 p. 190).

<sup>8</sup> This definition leaves out many informal sanctions, including those identified in Harel and Klement (2007) where losses incurred by convicts are in the form of a reduction in the probability of selling goods or services to purchasers. In Harel and Klement (2007), purchasers are motivated, at least in part, by fear of being sanctioned by third parties for dealing with convicts.

The two claims are that interactions between reputational and formal sanctions have been overlooked in the literature,<sup>9</sup> and that such interactions may make it inappropriate to substitute “a reputational sanction for a legal sanction”.<sup>10</sup>

Contrary to the first claim, as I demonstrate in Section 2, interactions between reputational and formal sanctions (and also the probability of detection) have been identified in Rasmusen (1996) in the criminal context.<sup>11</sup> Moreover, although the second claim may technically be correct, as I demonstrate in Section 3, it is not very relevant, because regardless of potential effects on reputational sanctions, an increase in the probability or severity of the formal sanction always deters. A trivial implication of these observations is that whenever deterrence is above [below] the desired level, it can be brought closer to the optimal level through a reduction [increase] in formal sanctions, regardless of how reputational sanctions react in response. Thus, with or without negative interactions the crucial inquiry is an empirical one: *how much* does an increase in formal sanctions (or the probability of detection) deter?

In this article, I construct a fairly general model of reputational sanctions to bridge the gap between the literature on reputational costs and stigmatization, and also to clarify the ambiguities regarding the nature of reputational sanctions. The model allows: productivity reductions (as in Rasmusen’s moral hazard model), adverse selection problems, correlations between people’s productivity and their benefits from offending, a positive proportion of undeterrable offenders, and changes in both the severity and certainty in the formal sanction (unlike Iacobucci’s model). Thus, Rasmusen’s two models of criminal stigmatization (reviewed in Section 2, below), as well as Iacobucci’s model of reputational sanctions, emerge as special cases of this model. The model is used to show that a negative relationship between deterrable individuals’ offense propensities and productivities is necessary for negative interactions between formal and reputational sanctions. Moreover, this type of correlation also allows the probability of detection to negatively interact with reputational sanctions, which is a result not identified in previous research. However, neither the probability nor the severity of the formal sanction can reduce deterrence in any specification of the model. Thus, the simple Beckerian result (that increasing the expected formal sanction increases deterrence) is unaffected by potential reductions in reputational sanctions.

The generalized model is also useful for comparing the properties of reputational sanctions with the properties of informal sanctions that do not fall within the definition of reputational sanctions provided above. Harel and Klement (2007), for instance, consider informal sanctions imposed by people who interact with ex-offenders partially due to pressures from third parties. These sanctions are not reputational, since they are at least partially motivated by a desire to “avoid punishment from others”. This distinction proves to be important, because as Harel and Klement show, in their framework, contrary to what I show here, an increase in the probability of detection (or formal sanctions) can reduce deterrence.

Another implication of the generalized model is that for unexpected effects on deterrence (through reputational sanctions) to be even theoretically possible, there needs to be additional,

perhaps indirect, effects. In Mungan (2015), for instance, I show that an increase in the formal sanction (or the probability of detection) for a relatively minor crime may affect the rate of a more serious crime, which in turn may reduce the deterrence of the minor crime by reducing the stigma attached to that crime. Although this type of interaction is a possibility, it requires significant interactions between the deterrence of the major crime and the stigma attached to committing the minor crime. Thus, the theoretical relevance of interactions between purely reputational sanctions and expected formal sanctions is yet to be demonstrated.

Next, I proceed with a brief review of Rasmusen (1996) and Iacobucci (2014) and show that the relationship between legal and reputational sanctions has been previously identified in the literature. I also identify and comment on the close relationship between Iacobucci (2014) and Rasmusen’s (1996) adverse selection model, and note how Iacobucci’s insight adds to this model. In Section 3, I construct a model in which Rasmusen’s (1996) models and Iacobucci (2014) emerge as special cases, and study how legal and reputational sanctions interact. I conclude in Section 4. An appendix in the end contains proofs of propositions 2 and 3.

## 2. Stigma, reputational costs, and the interaction between formal and reputational sanctions

Rasmusen (1996), sometimes called the “seminal article” on stigma,<sup>12</sup> considers a moral hazard model and an adverse selection model, where stigmatization emerges as a result of the profit maximizing self-interested behavior of employers. The moral hazard model assumes a fall in the productivity of a worker after he commits crime. This implies that the average productivity of individuals with criminal records is lower than the average productivity of people with clean records. Employers are only willing to pay the average productivity to both groups of individuals, and therefore a convict expects to earn a lower wage in the labor market than a person without a record. The adverse selection model produces a similar result, but through a different assumption. It assumes that people with low productivity always commit crime whereas high productivity people commit crime only if the expected sanction is sufficiently low. Thus, when sanctions are high, high productivity individuals earn more than low productivity individuals. In both models, the difference between the wages for unconvicted people and ex-convicts is what causes the stigmatization effect.

Iacobucci (2014) builds a model that is very similar to the adverse selection model in Rasmusen (1996). He considers firms who may decide not to comply with the law, and thereby save the cost of compliance. Unlike in Rasmusen’s adverse selection model, all firms are deterrable, but, they may have high or low compliance costs. These costs are assumed to be negatively correlated with the quality of the firms’ products. Purchasers are assumed to observe firms’ compliance behaviors, and from them they infer the expected quality of firms’ products. Hence, just as in Rasmusen’s adverse selection model, a gap can emerge between the prices purchasers are willing to pay to complying versus non-complying firms, which results in reputational costs.

Some similarities between the two models are worth highlighting. Just as purchasers of products in Iacobucci (2014) penalize offense history out of self-interest, so do the employers in Rasmusen (1996); purchasers and employers use offense history as a proxy for the quality or productivity of the firm or worker. Also, the additional sanction is in the form of reduced earning in both

<sup>9</sup> Iacobucci (2014 p. 192).

<sup>10</sup> Id. at 199.

<sup>11</sup> Iacobucci refers to several other articles in the literature on the economics of stigma, however, does not mention Rasmusen (1996), which analyzes stigma as a reputational sanction. Iacobucci’s discussion of the literature suggests that he views reputational effects and stigma as mutually exclusive categories. See, e.g., Iacobucci (2014, p. 190): “While both stigma and reputational penalties are important in different circumstances, I focus in this article on purely reputational penalties.”

<sup>12</sup> See, e.g., Faure and Escresa (2011, p. 207).

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