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# The Regressive Nature of Civil Penalties*

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## I. Introduction

The Federal Trade Comission (FTC) is empowered to seek civil penalties in district court against firms found in violation of the Comission's rules and orders. The provisions of the FTC Act which authorize such penalties are vague with respect to size, stating only that penalties shall not exceed $10,000 for each violation, each day of noncompliance constituting a separate violation. In determining the total amount, the Comission is instructed to consider "the degree of culpability, and history of prior such conduct, ability to pay, effect on ability to continue to do business, and such other matters as justice may require."[1]

Most previous discussions of enforcement strategies for civil violations omit details about the implementation of monetary remedies. Gary Becker, in his theoretical work on crime in general, pointed out that in focusing on optimal policies he had paid little attention to actual policies although he believed a positive correspondence might exist

and desist orders pay higher fines than first offenders or nonrespondents, the majority of the variation in civil penalty amounts is explained by variations in firm size, where "size" is measured by sales. Moreover, an increase in firm size results in a less than proportional increase in penalty, ceteris paribus. Thus, civil penalties operate as a regressive tax.

The data and empirical results are contained in the following section. Concluding remarks are offered in Section III.

## II. Empirical Determinants of Civil Penalties

The Commission interprets its rather broad enforcement mandate as requiring that it adopt a "flexible judicial" approach in assessing civil penalties.[6] According to this approach, monetary fine determinations are made on the basis of certain statutory, judicial, and practical requirements that attempt to balance the sometimes conflicting goals of deterrence, consumer compensation, and industry guidance.

In this section we investigate empirically the factors that enter into the determination of civil penalty amounts by the FTC. To do so we estimate the following regression model which incorporates criteria consistent with judicial flexibility in setting fines.

$$\text{PENALTY} = b_0 + b_1 \text{ SALES} + b_2 \text{ SALESSl} + b_3 \text{ ISl} + b_4 \text{ SUBSID} + b_s \text{ ABLE} + b_6 \text{ INST} + b_7 \text{ LARGE} + b_a \text{ GUILT} + b_g \text{ OTHER} + b_{10} \text{ PROG I06} + b_{11} \text{ PROG L03} + e,$$

where

SALES = Annual sales of respondents;

SALES 51 = Sales of firms violating §5(1);

ISl = §5(1) dummy variable (= 1 if violation of §5(1), = 0 otherwise);

SUBSID = subsidiary dummy variable (= 1 if case involves a subsidiary of a larger firm, = 0 otherwise);

ABLE = ability-to-pay dummy variable (= 1 if firm considered able to pay, = 0 otherwise);

INST = installment dummy variable (= 1 if fine paid in installments, = 0 otherwise);

LARGE = injury dummy variable (= 1 if violation thought to cause "large" consumer injury, = 0 otherwise);

GUILT = culpability dummy variable (= 1 if respondent acted in bad faith, = 0 otherwise);

OTHER = remedy dummy variable (= 1 if other remedies imposed, = 0 otherwise);

PROG I06 = program code dummy variable (= 1 if program I06, = 0 otherwise);

PROG L03 = program code dummy variable (= 1 if program L03, = 0 otherwise); and

e = regression error term

Sales to varying degrees can serve as a surrogate for g

alternative given up by the consu er to purchase the mis-represented com odity.[8] Since the degree of consu er injury will be specific to each case, no systematic relationship with sales revenue may be apparent.

In a simple bureaucratic model, the relative size

Section 5(1) dummy variable, I51, permit us to test whether the Commission treats these provisions differently, i.e., whether the regression slope and intercept differ according to statutory authority.

SUBSID indicates whether the sales data are for a corporate subsidiary or for a company as a whole. This dummy variable allows us to make inferences about alternative enforcement strategies in the case of multi-product firms. If one assumes that economic gain relates most directly to the revenue from the product line involved in the violation, then bringing cases against subsidiaries would be consistent with a deterrence strategy.[10] In contrast, if subsidiary status is associated with larger fines, a concern with ability to pay could be inferred.

Inclusion of the variables ABLE and INST provide a more direct test of the ability-to-pay proposition. In particular, ABLE is assigned a value of unity if the respondent was considered able to pay a monetary fine, and INST indicates the presence of an arrangement to pay the penalty in installments. Inability to pay or necessity for a series of payments might indicate that the respondent's financial condition is viewed as weak, perhaps inducing the Commission to lower the total size of the penalty.

given range for similar types of infractions, with values within the range varying according to mitigating or aggravating circumstances. To test for such an effect we classi-

Information on some of the qualitative explanatory variables included in the regression was not always available for every case. The staff memoranda may have discussed consumer injury in one case, culpability in another, and ability to pay in still another. Rarely were all mitigating and aggravating circumstances covered in the context of any single respondent. Such missing observation problems were handled by the method of modified zero order regression.[14]

Sample statistics by FTC progra area are listed in Table 1. The smallest civil penalty assessed by the Comission between 1979 and 1981 was $1,000; the largest was $1,750,000. On average, the heaviest fines were imposed for violations of outstanding orders and for Equal Credit Opportunity Act infractions. Deceptive sales practices drew the smallest average penalties.

## The Results

Our empirical model suggests that civil penalty amounts are a positive function of firm size as measured by sales and are also affected by mitigating and aggravating circumstances reflecting company financial condition, extent of consumer injury, degree of culpability, imposition of other remedial requirements, and institutional factors associated with statutory authority and type of violation.

The regression results are presented in Table 2.[15] Overall, variations in the explanatory variables explain 85 percent of the variation in civil penalty amounts. With the exception of the extent of consumer injury, all parameter estimates are significantly different from zero at the 1 percent level.[16]

<u>Sales and FTC Act Authority</u>. Firm size is apparently an important consideration in setting civil penalty amounts. (In fact, variations in sales alone explain 58 percent of the variation in monetary fines.)[17] The coefficient on SALES indicates that a 1 percent increase in firm size results in a .23 percent increase in penalty amount, suggesting that the penalty burden falls p. y i .: ii aep0

Table 1

Sample Civil Penalties by Program Area, 1979-1981

| Program Area | Number of Cases | Average Penalty | Standard Deviation |
|---|---|---|---|
| Cigarette Advertising Practices | 6 | 97,000 | 7,144 |
| Deceptive Sales Practices | 4 | 10,000 | 0 |
| Business Opportunities, Franchising | 1 | 25,000 | -- |
| Children's Advertising | 1 | 100,000 | -- |
| General Credit Practices | 8 | 51,000 | 36,198 |
| Equal Credit Opportunity Act | 4 | 115,000 | 88,412 |
| Credit Information | 14 | 36,600 | 22,636 |
| Rule and Statute Enforcement | 5 | 21,000 | 4,183 |
| Compliance | 14 | 161,000 | 459,561 [a] |

[a] The high variation in the Compliance program area is because it included both the highest (Readers Digest, $1,750,000) and the lowest (R. Paron, $1,000 and Tri-West Construction, $2,000) penalties.

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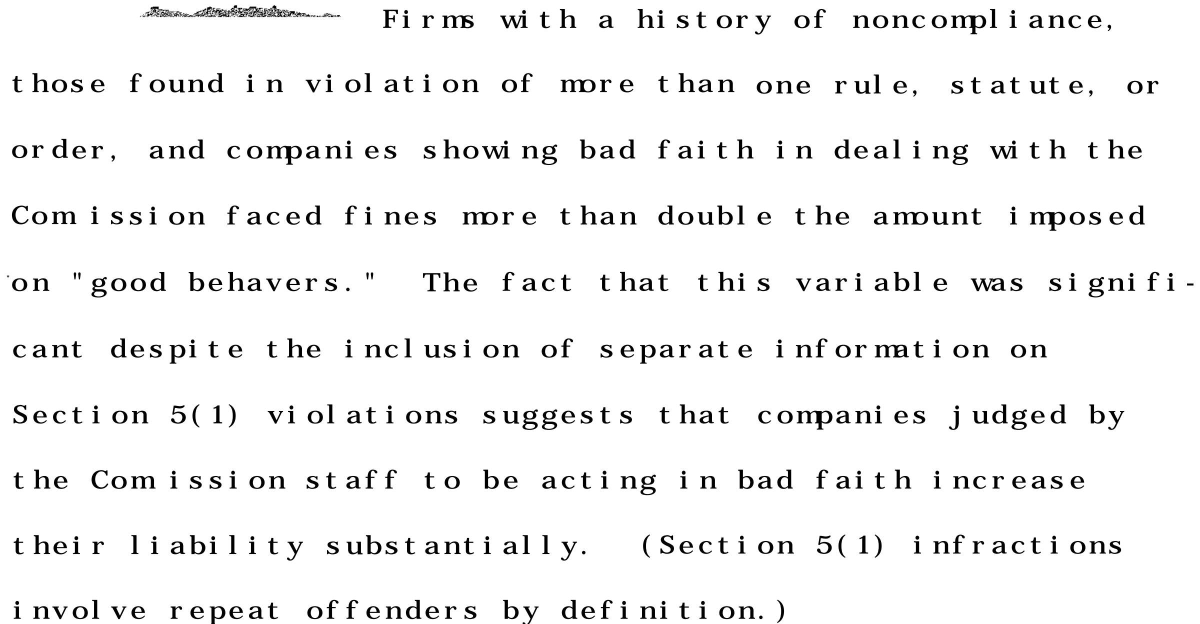
<u>Ability to Pay</u>. When financial condition was discussed in internal Commission documents and the respondent was judged able to pay, the fine tended to be almost 70 percent higher than when the firm was considered unable to pay. This finding, together with the significance of subsidiary status discussed above, suggests that ability to pay is an important determinant of civil penalty amounts.

The conjecture that penalty payment by installments might be a sign of financial weakness and therefore be associated with



Firms with a history of noncompliance, those found in violation of more than one rule, statute, or order, and companies showing bad faith in dealing with the Comission faced fines more than double the amount imposed on "good behavers." The fact that this variable was significant despite the inclusion of separate information on Section 5(1) violations suggests that companies judged by the Comission staff to be acting in bad faith increase their liability substantially. (Section 5(1) infractions involve repeat offenders by definition.)

Other Remedial Provisions. The inclusion of additional relief measures in civil penalty cases tends to raise the amount of the fine rather than reduce it. When other remedies were imposed along with fines to form a larger relief package, the expected size of the penalty was increased by 73 percent. This suggests that consume compensation and non onetary remedies serve as complements to and not substitutes for direct fines.

Type of Violation. The regression model tested for the existence of consistency and predictability among types of violations by including du yn variables for the Comission program areas responsible for bringing each of the cases. Differences between program areas would indicate that consistency within specific types of violations was an important concern in setting penalty size. The results did

not

## III. Concluding Remarks

In this paper we have reported results from an empirical analysis of the factors that have entered into the determination of civil penalties assessed by the FTC in its consumer protection mission. Based on data derived from 57 civil penalty cases before the Comission between 1979 and 1981, we found evidence that suggests monetary fines transfer wealth from small firms to large fir s. In partieular, nearly 60 percent of the variation in civil penalty amounts was explained by variations in firm size, where "size" was measured by sales.

Moreover, an increase in

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We also found that judgments concerning respondents' ability to pay and their degree of culpability were important in explaining the size of fines. That is, violators that were subsidiaries of larger companies or that were otherwise thought to be able to bear monetary penalties paid higher fines than did other respondents. In addition, firms acting in bad faith or showing a history of noncompliance faced stiffer penalties than first offenders or good behavers. Moreover, other relief measures appeared to serve as complements to and not substitutes for direct monetary fines. Finally, neither the extent of consumer injury caused by a violation nor a concern with consistency within particular types of infractions appeared to be given much considerftaion y of

## Appendix

Cases Included in Sample with Size of Civil Penalty

| | Respondents | Civil Penalty |
|---|---|---|
| 1. | American Brands | $100,000 |
| 2. | A oco (Standard Ind.) | 200,000 |
| 3. | A. Abraha | 25,000 |
| 4. | Associated Dry Goods | 75,000 |
| 5. | Atlantic Hosiery | 16,000 |
| 6. | Atlantic Industries | 10,000 |
| 7. | Britene Interntl Textiles | 20,000 |
| 8. | Brown & Williamson | 100,000 |
| 9. | Budget Marketing | 125,000 |
| 10. | Cadence Industries | 50,000 |
| 11. | Capital Credit | 75,000 |
| 12. | Centex (Midwest) | 50,000 |
| 13. | Collectron & Telechek | 65,000 |
| 14. | Credit Rating Bureau | 10,000 |
| 15. | Crosland | 20,000 |
| 16. | Dixieland | 10,000 |
| 17. | Downing | 10,000 |
| 18. | Exxon | 100,000 |
| 19. | General Mills | 100,000 |
| 20. | Georgia Telco | 10,000 |
| 21. | Hylton | 28,000 |
| 22. | Intaltex | 15,000 |

Appendix (cont'd)

| | | Civil Penalty |
|---|---|---|
| 23. | Ivy International | 25,000 |
| 24. | Kettler | 25,000 |
| 25. | Lawson Hill | 15,000 |
| 26. | Liggett | 82,500 |
| 27. | Lorillard | 100,000 |
| 28. | Maralco Enterprises | 15,000 |
| 29. | Modern Home | 10,000 |
| 30. | Mod-Maid Imports | 25,000 |
| 31. | Montgomery Ward | 175,000 |
| 32. | National Siding | 10,000 |
| 33. | Nationwide | 10,000 |
| 34. | Neighborhood Periodicals | 150,000 |
| 35. | Phillip Morris | 100,000 |
| 36. | Pulte Home | 70,000 |
| 37. | Radiology Consultant | 30,000 |
| 38. | Readers Digest | 1,750,000 |
| 39. | R. Paron | 1,000 |
| 40. | Ricardo Pagnini | 20,000 |
| 41. | R. J. Reynolds | 100,000 |
| 42. | RJR Foods | 70,000 |
| 43. | Scarborough | 50,000 |
| 44. | Edward W Scott | 10,000 |
| 45. | Sure Products | 30,000 |

## Appendix (cont'd)

| | Respondents | Civil |
|---|---|---|
| 46. | Tasemkins Furniture | 20,000 |
| 47. | Tri-Texas, Inc. | 25,000 |
| 48. | Tri-West Construction | 2,000 |
| 49˘! | United Corp. | 15,000 |
| 50. | Universal Collection | 90,000 |
| 51. | ž˘Ł˘! Homes | 90,000 |
| 52. | Van Schaack | 30,000 |
| 53. | Virginia Builders | 30,000 |
| 54. | Wauwatosa Realty | 15,000 |
| 55. | Westminster | 50,000 |
| 56. | Yeonas | 25,000 |
| ;7. | Young Ford, Inc. | 10,000 |

## Footnotes

*The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Federal Trade Comission, its staff, or any individual Comissioner. We are grateful to Robert Tollison and Richard Higgins for coments on an earlier draft. The usual caveat applies.

[1] Section 5(m)(1)(c) of the FTC Act, Pub. L. No. 93-637, title II, Sec. 205, 88 Stat. 2200 (1975). Codified as 15 ž˚Ł˚fi˙! Sec. 45(m) (Supp. V 1975).

[2] Gary Becker, "Crime and Punishment: An Economic Approach," 76 Journal of Political Economy 169 (1968).

[3] George Stigler, "The Optimum Enforcement of Laws,"

[5] See Colin Diver, "The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies," 79 Columbia Law Review 1436 (1979).

[6] FTC Bureaus of Consumer Protection and Economics, Civil Penalties: Policy Review Session, July 1982.

[7] A. Michael Polinsky and Steven Shavell, "The Optimal Tradeoff Between the Probability and Magnitude of Fines," 69 American Economic Review 880 (1979).

[8] Sam Peltzman, "An Evaluation of Consumer Protection Legislation: The 1962 Drug Amendments," 81 Journal of Political Economy 1049 (1973).

[9] See David Bickart, "Civil y P. g dy g "A.

11 Instances of bad faith include,-those respondents with a history of noncompliance and fir s violating more than one rule, statute, or order.

12 There were actually 66 civil penalty cases during the 1979-1981 period. Four were excluded from our sample because sales data were not available. These were Haband Company ($30,000 penalty), Macmen Financial Services ($20,000 penalty), National Talent Associates ($25,000 penalty), and Womack Nursery ($10,000 penalty). Five other cases were excluded either because their files were missing or because the matters were still active: J.B. Williams ($75,000 penalty), Sydney N. Floersheim ($75,000 penalty), Korman Corp. ($35,000 penalty), Paul Ramage ($10,000 penalty), and National Dynamics ($100,000 penalty).

13 Sales data generally were for the most recent year in which the violation was said to-have occurred.

14 See Jan Kmenta, Elements of Econometrics (1971), pp. 336-44.

15 Sales and penalty values were deflated by the consu er price index and then transformed by taking natural logarithms.

16 The results therefore do not display the symptoms of multicollinearity, a frequent problem with three or dum y variables.

[21] See Benjamin Klein and Keith Leffler, "The Role of Market Forces in Assuring Contractual Performance," 89 615 (1981).