The Effectiveness of Regulatory Penalties in the Public Sector

Key messages:

- **The type of punishment that induces compliance in the public sector may differ from that of the private sector: non-monetary factors, such as recognition, may be more impactful.**
- **Reducing regulatory burdens, improving understanding of regulation and ensuring ability to comply is likely to increase public sector compliance. To leverage the spill-over effects of public sector regulatory action effective communication that builds public awareness is essential.**
- **Within EU GDPR, EEA member states may lay down national law regarding the extent to which administrative fines may be imposed on public authorities. The majority of EEA countries (22 of 30) have taken up the option of establishing different laws for public authorities, consistent with the theoretical evidence. Only a small minority of EEA countries (6) do not have specific laws around administrative fines for public authorities, similar to the UK approach**.

Context

This note draws together a range of evidence sources regarding the effectiveness of regulatory penalties for the public sector, looking at economic theory, empirical evidence and evidence on the approach to imposing administrative penalties on public authorities in the European Economic Area (EEA).

Literature review

Economic theory

The ICO's powers include the ability to impose monetary penalties where the laws that we regulate have been breached. These penalties aim to be "*effective, proportionate and dissuasive*" in the circumstances, ensuring they both punish organisations in breach and promote future compliance.[1]

From the social planner's perspective, regulatory compliance and enforcement is a problem of **allocation of scarce resource**. Both non-compliance and enforcement diminish social welfare. Optimal enforcement aims to minimise social loss by setting the marginal cost of enforcement equal to the marginal cost of non-compliance.

As Becker (1968) identified, from the regulated organisation's perspective, **the incentive to offend is driven both by the probability of being caught and the severity of punishment** if detected and convicted.[2] The intuitive consequences of this are that dissuasiveness is enhanced by greater penalties, as well as increased likelihood of detection and conviction.

[1] See: Statutory guidance on our regulatory action, pp. 19-20.
[2] Becker, G (1968) Crime and Punishment: an Economic Approach

This idea is expanded on by Stigler (1970) who introduced the concept of **marginal deterrence**. Penalties need to be proportionate to avoid creating perverse incentives to commit more harmful offenses.

Harrington (1988) finds that **firms are highly likely to comply when the costs of doing so are low**, and that it's possible for **non-monetary factors to also incentivise compliance**, such as reputational damage from poor publicity. To have this effect, regulators need to be adept at spotting breaches and communicating enforcement action effectively.

Research from Evans et al (2015) analyses how penalties handed down by an environmental regulator to non-compliant firm creates **positive spill over effects** for other firms.[3] The authors show that enforcement action strengthens the regulator's reputation, having a positive effect on compliance in other organisations. Penalties that can leverage spill over effects will therefore have a broader dissuasive effect, helping resource constrained regulators to achieve their priorities.

Evans et al (2015) also find that 'in an uncertain regulatory environment, potential violators update beliefs about their own expected penalties based on recent experiences of those around them.'[4] Whereas 'tough' enforcement can lead to positive regulatory spill over results; 'weak' enforcement is likely to lead to negative spill over. **To establish positive spill overs, uncertainty needs to be minimised so regulated entities understand the potential action they face.**[5] This implies that if monetary penalties in the public sector are removed, an alternative mechanism, such as a public reprimand, should be deployed to signal regulatory certainty to other regulated entities.

In the public sector, evidence suggests that **financial incentives are less impactful as there is no profit motive.** Public sector organisations respond to factors such as political influence, budget-setting and bureaucratic management and therefore to influence bottom line approaches other than financial sanctions should be considered. **Financial penalties end up either paid by taxpayers in terms of greater budgets; or services users in terms of reduced services.** This argument is backed up by literature from the legal and public administration literature.[6] [7]

Mulgun and Albery (2003) further support this idea, arguing that *'a sense of pride and contribution to public service and the creation of public value'*[8] are more powerful incentives in the public sector than monetary factors.

Empirical evidence

Empirically there is a paucity of evidence around the impact of monetary penalties and their impact of the public sector. One study comparing public and private sector water companies during Czechoslovakia's transition to a market economy in the 1990s examined the impact of monetary penalties for environmental damage.

The paper argues that in the private sector, monetary penalties damage profit and therefore firms will be willing to bear costs to avoid them. In the public sector, in the absence of a profit motive, monetary

[3] See: Evans, M et al (2015) Enforcement spillovers: Lessons from strategic interactions in regulation and product markets.
[4] ibid
[5] ibid
[6] No GDPR fines for public sector bodies at all? No discrimination, and no problem! | International Network of Privacy Law Professionals (inplp.com)
[7] Public and private values at odds: can private sector values be transplanted into public sector institutions? - LARSON - 1997 - Public Administration and Development - Wiley Online Library
[8] An evolving, not finished piece of work (oakland.edu)

penalties have no impact on the individuals responsible for avoiding them and therefore do not induce a behavioural change. The impact of a monetary fine will be passed entirely onto consumers in terms of lower service levels. The article concludes that in the centrally planned economy**, monetary penalties are a form of show, designed for external perceptions rather than to induce change directly from the organisation subject to them**.[9]

Implications for the public sector

This review of theoretical and empirical literature suggests the following implications for regulation of the public sector.

1) The type of punishment that induces compliance may differ from that of the private sector: non-monetary factors, such as recognition, may be more impactful.
2) Reducing regulatory burdens, improving understanding of regulation and ensuring ability to comply is likely to increase compliance.
3) To leverage the spill-over effects of regulatory action effective communication that builds public awareness is essential.

Cross-country comparison

Approach to imposing administrative penalties on public authorities in EEA countries

The European Union's General Data Protection Regulation (GDPR) was designed to apply to all types of organisations, from multi-nationals down to micro-enterprises and across the public sector, and applies to countries in the European Economic Area (EEA).[10] The fines imposed by the GDPR under Article 83 are flexible and scale with the organisation. For the most serious infringements, a fine of up to €20 million, or 4% of the firm's worldwide annual revenue from the preceding financial year, whichever amount is higher can be imposed.[11]

Within the EU GDPR, EEA member states may lay down national law regarding the extent administrative fines may be imposed on public authorities. Reflecting the theoretical and empirical evidence noted, 24 of the 30 EEA countries have taken up the option of establishing different laws for public authorities, as shown in Table 1 below.

Of the 30 EEA countries covered by EU GDPR:
- 11 do not permit the imposition of administrative fines on public bodies;
- 11 limit administrative fines on public authorities;
- 2 apply the same rules to the public and private sector; and
- 6 have no specific rules around administrative fines for public authorities.

It is notable that **the UK approach reflects the small minority of EEA countries that do not have specific laws around administrative fines for public authorities**.[12]

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[9] Optimal Mix of Penalties in a Principal-Agent Model under Different Institutional Arrangements (jstor.org)
[10] In 2018 when EU GDPR came into force, the EEA consisted of 28 EU countries plus Iceland, Liechtenstein and Norway.
[11] What are the GDPR Fines? - GDPR.eu
[12] The following countries have no specific rules around administrative fines for public authorities: Bulgaria; Iceland; Italy; Latvia; Slovakia; Spain.

Table 1: EEA countries and maximum administrative fine imposable on public authorities for breaches of GDPR as laid down in national law

Country	Maximum possible fine	Bodies subject to specific rules as 'public authorities'
Austria	€ 0	Public authorities and public bodies
Belgium	€ 0	Government or its servants or agents, except those offering goods or services on the market
Croatia	€ 0	Public authority
Cyprus	€ 200,000	Public authority carrying out not-for-profit activity
Czech Rep	€ 390,000	Public authorities
Denmark	€ 2,100,000	Public authorities
Estonia	€ 0	State authorities
Finland	€ 0	Public authorities, public bodies, Evangelical Lutheran or Orthodox Church of Finland
France	€ 0	Public authority
Germany	€ 0	Public authorities and public bodies
Greece	€ 10,000,000	Public authorities
Hungary	€ 55,000	Public authorities
Ireland	€ 1,000,000	Public authorities and public bodies providing it is not acting as an undertaking within the meaning of the Competition Act 2002
Liechtenstein	€ 0	Public authorities and public bodies
Lithuania	€ 60,000	Public institutions
Luxembourg	€ 0	The State or municipalities
Malta	€ 50,000	Public authority
Netherlands	€ 0	Public authority
Norway	Same rules apply to the public as private sector	Public authority
Poland	€ 23,300	Public authority
Portugal	Same rules apply to the public as private sector	Public authority
Romania	€ 42,000	Public authority
Slovenia	€ 0	Public authority except with respect to biometric data where fines may be issued
Sweden	€ 940,000	Public authority

Source: GDPR Guide to National Implementation | White & Case LLP (whitecase.com) (Published November 2019)