Chapter 1

The Changing Patterns of Punishing When a Country Gets Rich

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1.1. INTRODUCTION

A very useful insight of law and economics is that all legal sanctions of civil law, administrative law and criminal law alike can be seen as instruments to achieve social goals. This leads to the idea prominently proposed by Shavell (1984) and widely discussed that the legal system can shift freely from one branch of the law to another depending on the desired deterrence effect of a legal sanction because civil liability, administrative fines and criminal sanctions are functionally equivalent.

The basic idea is straightforward. Assume that a criminal act can be effectively deterred with a prison sentence. Then there is an amount of money whose disgorgement to the victim or the state as either a civil liability payment or as an administrative fine has the same deterrence effect, provided the enforcement error remains the same under criminal punishment, civil liability or administrative fine. Why then punish people at all with prison sentences if cash payment yields the same deterrence result? One could replace the criminal sanction by civil liability or administrative fines. One principal reason why this is not possible is that often most people do not have the money, are judgment proof and cannot be deterred by a civil sanction. What about fines? It is a well-established research result that the optimal fine to deter a violation of the law is immensely lower than the liability payment for harm. A fine can punish the harmful act like violating a traffic rule or an environmental standard or a rule of competition law and is not contingent on an actual damage.

From this it follows that civil sanctions can fully deter rich people whereas only prison sentences can deter poor people. The principle of equality

before the law prohibits or restricts punishing only the poor with prison sentence. This insight is however not worthless for a legislator because it not only applies to different income groups within the same country but also to different countries with different per capita income levels. A poor nation relies more on imprisonment than a rich nation (Cooter, Schäfer 2012, p. 142). If a poor country gets richer and most people can pay a damage award or an administrative fine the general necessity to jail offenders for reasons of deterrence becomes less obvious. If general deterrence is the driving force of criminal law we should therefore observe more criminal law in poor than in rich countries and we should also expect that decriminalization is a pervasive feature of a changing legal culture when a once poor country becomes rich.

1.2. THE TWO FACES OF PUNITIVE DAMAGES

However this is not what we generally observe. And especially there are large differences between European countries and the USA. In Germany we had a wave of decriminalization in the 1970s, but not much more since then. Especially one cannot observe a general trend to replace criminal sanctions by civil and administrative sanctions. The German constitution would allow this only to a very limited extent.[1]

In the USA however the trend to use civil liability for deterrence purposes is more widespread for instance by the use of multiple or punitive damages. They are aimed to discourage willful, reckless and in some states even gross negligent behavior and can therefore be regarded as a civil substitute for criminal sanctions (Brockmeyer 1999, p. 3). Law and economics scholars have proposed to use punitive damages independent from intent or negligence to correct for enforcement errors. To maintain the deterrence effect liability should be doubled if only 50 per cent of the cases are brought to court. They should be tripled if only one third of all cases are brought to court etc. In Germany we observe nothing of this kind and civil damage awards are – with some exceptions – - confined to compensate the victim. They cannot be increased for the sole purpose of deterrence. Punitive damages are even unconstitutional.

[1] The landmark decision of the German Federal Court is from 1992 (BGHZ 118, 312 = NJW 1992, 3096). „*Hingegen fallen Sanktionen, die der Bestrafung und Abschreckung – also dem Schutz der Rechtsordnung im Allgemeinen – dienen, nach deutscher Auffassung grundsätzlich unter das Strafmonopol des Staates. ... Aus hiesiger Sicht scheint es unerträglich, in einem Zivilurteil eine erhebliche Geldzahlung aufzuerlegen, die nicht dem Schadensausgleich dient, sondern wesentlich nach dem Interesse der Allgemeinheit bemessen wird.*" (Sanctions, which serve the purpose of punishment and deterrence, that is the protection of the legal order in general fall under a state monopoly to punish. From our perspective it is unacceptable that a civil court imposes a considerable damage payment, which does not serve the purpose of damage compensation but is calculated to serve the public interest.)

All in all the general opinion of lawyers in Germany is that private punishments violate the state monopoly to punish and therefore also violate the *ordre public* (Rieble, in: Staudinger, BGB, vor § 339 Rdnr. 128). The legal consequence of this position is that foreign court orders of civil courts, which contain punitive damages, are not enforced in Germany.

In spite of a law enforcement treaty between Germany and the United States, which obliges German authorities to execute American court orders, punitive damages are not enforced and sometimes courts even deny delivery of the court order to the defendant, because this would violate the German *ordre public*. In other words this form of decriminalization is welcome in the USA but heavily criticized and unconstitutional in Germany. What explains this difference?

Criminal sanctions cut deeper into the wellbeing of the offender than civil or administrative sanctions especially due to the labeling effect. Why then not embrace full heartedly the replacement of civil over criminal sanctions, if the latter can provide sufficient deterrence?

Criminal law has two faces, which may lead to a state monopoly of punishment in some legal orders. Its sanctions and their consequences for the offender are harsher than a damage award and stigmatizing, but the criminal procedure protects the defendant against court errors to an extent, which does not exist for the procedures in other fields of the law. Decriminalization through civil sanctions has therefore an upside and a downside. The downside is the weaker protection under the civil or administrative procedure in the case of administrative fines or civil punitive damages. The criminal procedure with its standard of proof beyond reasonable doubt, its testimonial privileges, its guaranteed right to a trial lawyer and interpreter paid unconditionally by the state and many other privileges of the accused reduces the quota of false convictions below the rate in a civil or administrative procedure. There exists therefore a tradeoff between decriminalization on the one hand and protection by the criminal procedure on the other. This trade off is solved differently in the USA and other countries, more in favor of decriminalization in the USA and more in favor of protection by the criminal procedure for instance in Germany.

1.3. DECRIMINALIZATION AND HUMAN RIGHTS, THE CASE *ÖZTÜRK V. GERMANY* AT THE EUROPEAN COURT OF HUMAN RIGHTS

But even in Germany some moderate steps to decriminalization could not be made without intervention of Supreme courts for instance the European Court of Human Rights. Here is an example. Germany decriminalized sanctions for traffic violations, including for instance false parking and punishes such violations as administrative offences. Not a judge but an administrative officer decides on the sanction[2]. The punishment with a monetary payment between 5 and 1,000 Euro does not imply a statement that the act is morally condemnable unlike for a criminal sanction. One motivation behind this was to take away the stigma attached to a criminal punishment.

This had the following consequence. Öztürk, a Turkish resident received an administrative fine of 60 Euro for hitting a car with his own car, which he did not accept. He went to court. After he lost the case he was

[2] Administrative fines are regulated in a special law, Ordnungswidrigkeiten-Gesetz (OWiG). In case of a legal dispute the criminal procedure applies with some exceptions.

denied state financing of a court interpreter, to which he would have been unconditionally entitled in case of a criminal charge. The criminal procedure in Germany burdens the convicted offender with the court costs, but not with the costs for an interpreter. The European Convention of Human Rights requires (Art. 6.3 (e)) for a "person charged with a criminal offense to have the free assistance of an interpreter if he cannot understand or speak the language used in court".

Oztürk moved the case to the European court of human rights. In the proceedings Oztürk vs. Germany the German government argued that Oztürk had not been charged with a criminal offence. Therefore the rule of Art. 6 of the European Convention of Human rights would not apply and Oztürk, who had lost the case must pay all court costs including the costs for the interpreter. The European court of human rights decided that this violates section 6.3 (e) of the European convention of human rights, under which this charge is a criminal charge even though it is not a criminal charge under German law. This example shows that not only in Germany but also in the whole Europe decriminalization in the sense of moving punishment into other fields of the law such as administrative or even civil law runs fast against constitutional and human rights barriers if the protective function of the criminal procedure is not preserved.

To shift functions of criminal law to administrative and civil law would cause similar problems. If therefore civil liability is used to punish with the explicit policy target of deterrence, stabilizing the public order and making a statement that the punished act is morally condemnable the procedures would have to be adapted.

1.4. DECRIMINALIZATION AND *ORDRE PUBLIC*, THE CASE *GENERAL MOTORS V. VOLKSWAGEN*

The differences between legal cultures can be illustrated with a spectacular transatlantic dispute, which could finally only be solved through direct negotiations at the highest political level, the case *General Motors v. Volkswagen and Lopez* (Brockmeyer 1999, p. 178).

Lopez was a manager at Opel Corporation, a German subsidiary of General Motors. He left the company together with a group of other employees. They were hired by Volkswagen Company, Lopez as a member of the management board in charge for production and sales. General Motor raised allegations against Lopez, that he had purloined know how and secret materials from Opel for his and Volkswagen's benefit and that the whole group acted as spies for Volkswagen. In Germany a criminal trial against Lopez was first not opened because the public prosecutor, probably upon instruction of the ministry of justice, decided that there was no public interest for a criminal charge against him (Brockmeyer 1999, p. 179).

In the United States however General Motors took action and claimed punitive damages of 20 bn. dollars against Volkswagen and Lopez under the

RICO act, Racketeer Influenced and Corrupt Organizations Act, a federal anti mafia law, which also allows for civil claims and multiple damages (Brockmeyer 1999, p. 140, 188). It is almost certain, that a US court order in this case would not have been enforced in Germany and that a German court would not even have forwarded the court order to the German defendants, in spite of the bilateral law enforcement treaty between the two countries because this would have violated the German *ordre public*. It is a firm legal position in Germany that damages which are much higher than necessary to fully compensate the victim for his losses for the only purpose of punishment and deterrence, are unconstitutional if the court decision is not made within the criminal procedure. The German Supreme Court argued in a landmark decision of 1992: "Sanctions having the rationale of punishment and deterrence serve the protection of the legal order in general and are therefore in a German perspective subordinated to the state's monopoly to punish. In our view it seems intolerable that a civil court imposes payments, which do not serve the compensation of damages but the interest of the public in general."[3]

This explains why punitive damage awards in the USA if they serve deterrence purposes are not enforced on German territory against defendants living in Germany. They are unconstitutional and violate the *ordre public* because they are decided outside the criminal procedure. To avoid tensions between the two countries the case was settled in negotiations on the highest political level between US president Clinton and the German chancellor Schröder. Lopez had to be dismissed as manager of Volkswagen Company. Volkswagen paid 100 million dollars damages to General motors and bought parts for 1 bn. dollars from General motors. A criminal charge against Lopez in Germany ended with a plea bargain. Lopez paid a criminal fine of 400,000 Euros to a German criminal court (Brockmeyer 1999).

1.5. EFFICIENT DETERRENCE AND PROCEDURAL PROTECTION BY THE CRIMINAL PROCEDURE

What explains such differences between two countries? There is little one can say to this as a law and economics scholar, I think. Decriminalization and the use of civil liability to efficiently deter acts which are traditionally deterred exclusively by criminal law might lead to better, less difficult and less costly general deterrence. But deterrence uses the individual as an instrument for policy purposes with harsh and stigmatizing consequences. This calls for a high level of protection under the criminal procedure. A tradeoff exists and one country might solve this trade off differently than another country. The USA has a tradition to impose a special responsibility for the whole community upon the individual citizen. In Germany, and I think in many European countries the fight against crimes is regarded as a state responsibility. Consequently, acts like the RICO act do not exist in Germany or Europe.

[3] (BGHZ 118, 312 = NJW 1992, 3096). Own translation.

Decriminalization and punishment by civil sanctions is certainly not without limits or critique in the USA. In a dissenting vote Supreme Court Justice Sandra O'Connor criticized in the case *Pacific Mutual life Ins. Co. v. Haslip* a punitive damage award of more than 1 million Dollars against the insurance company as unconstitutional. The insurance company had not paid a bill of 2,500 Dollars to which the plaintiff was clearly entitled. Justice O'Connor regarded the punitive damage of one million dollars as a violation of constitutional rights of the defendant because the jury had not been properly informed about the rationale of punitive damages. In the USA it is also disputed, whether high punitive damages violate the constitutional principle of due process (Brockmeyer 1999, p. 23)[4]. These and related difficulties arise if one discusses decriminalization.

The rejection of civil punishment in Germany does not exclude large monetary fines. Large payments, which go into the hundreds of million Euros for violating German or European competition law are possible, but not within civil law. In Germany they are regulated under a procedure (*Ordungswidrigkeitengesetz*), which is close to the criminal procedure, however with some reduction of protection, sometimes called "criminal law procedure light". Under this procedure it is possible to levy fines, including double or triple damages as required. But this procedure still protects the defendant better than the administrative or civil procedure as most rules of the criminal procedure apply.

1.6. DAMAGES AS A DECISION MECHANISM FOR EFFICIENT TRANSACTIONS VERSUS DAMAGES AS A DETERRENT INSTRUMENT

There is another fundamental difference between criminal punishment and classical tort liability, which is related not to procedural but to substantive law. Criminal acts are by definition condemnable and should not happen at all in an ideal world. If a society tolerates positive crime levels, then it is not because these have any social value, but because it is either too costly or too brutal to deter them all. Civil liability and especially tort liability in its traditional meaning is crucially different as Calabresi and Melamed (1972) have famously argued. It is not a deterrence instrument like criminal punishment but a method to allow for involuntary but socially efficient and desired transactions if voluntary transactions are impractical. Take the case of a polluting firm which causes damages in the neighborhood and is liable in damages. Assume for simplicity's sake that the pollution per unit of production is technically unavoidable and cannot be further reduced. In this case civil liability has not the rationale of deterring pollution as a condemnable activity but of finding out whether the pollution is socially beneficial or socially detrimental at this particular place. If in spite of the liability payments the company is still profitable, for instance if only a few residents in the vicinity claim compensation, the company

[4] See also Shepherd (2013).

will continue to stay there and this is socially efficient. If however liability payments wipe out all profits because there is a huge residential neighborhood around the production site, the production site will be closed and removed. And this is also socially efficient. Civil liability is therefore often a decision mechanism which makes efficient economic activities profitable and inefficient activities unprofitable. If civil liability is used to deter criminal activities which are socially undesired per se this would lead to far reaching changes in the legal and dogmatic structure of civil liability. It would specifically require courts and judges with a fine understanding about when liability serves as a decision mechanism to separate efficient from inefficient economic activities and when liability serves as a substitute for criminal sanctions. If this is not guaranteed it might be better to keep criminal and civil sanctions separated in two different categories of the law.

1.7. REDUCING THE SCOPE AND CHANGING THE NATURE OF CRIMINAL PUNISHMENT. CRIMINAL MONETARY FINES

The basic insight that increasing wealth of a nation allows to achieve deterrence more with monetary payments instead of imprisonment is in no way questioned by the inherent difficulties to move such payments to the civil liability system. Payments can be organized within the criminal law system itself. Such payments have a huge economic advantage over imprisonment as economically speaking monetary fines are transfer payments and therefore socially costless. They reduce the utility levels of those, who have to pay them and increase the utility level of those who benefit from these transfers. In that sense they are costless. Imprisonment however is costly. A recent study for the state of Hessen in Germany estimates the daily cost for a prison inmate at about 89 Euros[5], roughly the price for a middle class hotel. If a 2 years prison sentence can be replaced by fines this would save the taxpayer the sum of 47.000 Euros. If in Germany the prison inmate population could be reduced by 10 per cent substituting with monetary fines this would decrease the costs for imprisonment by 236 million Euros per year. This rough calculation is based on prison inmate statistics from the OECD (2010).

The sentence of a criminal court can consist of a prison sentence or a monetary fine, which is replaced by prison in case the defendant does not pay. According to Shavell (1984, 1985) and others, several factors must be taken into account for the fine to deter,. Firstly, the fine must be marginally higher than the benefit of the crime for the offender. Secondly, it must be corrected for the enforcement error. If only 50 per cent of the crimes are detected and lead to a criminal sanction, it must be doubled, if only one third are detected, the fine must be tripled etc. A third factor is of importance if the fine should replace fully or partly a prison sentence. It must be higher than the defenders

[5] In the different German states the average costs of imprisonment varied in the period 2001–2003 from 69 Euros in Bavaria to 126 Euros in Brandenburg. See Entorf (2006).

loss of utility from the prison sentence. If an offender values for instance one day less in prison at 200 Euros, a fine with the same deterrence effect as one day in prison must be marginally higher than 200 Euros. A rough rule of thumb is that one day in prison should be equivalent to two days in freedom at the subsistence level. This would require that a fine which replaces one day in prison is at least the wrongdoer's income of two days minus the subsistence income of two days.

It is therefore evident that the design of criminal fines is flawed in some countries. In Thailand for instance fines are fixed amounts equal for each offender and specified in the law. They cannot serve the purpose as they over-deter some potential offenders and under-deter others. Also with inflation and raising per capita income the legally specified amount loses any deterrence effect over time, if parliament does not continuously change the amounts. But parliaments have not the capacity for this type of micromanagement. This flawed design was also used in Germany until 1975 when a reform following the Scandinavian example introduced daily fines. Section 46 I S. 1 StGB (German Criminal Code) entitles the judge to fix the daily fine himself according to general principles of the criminal law.[6] The level of the fine reflects the severity of the crime, the level of individual responsibility and the income level of the defendant. Since then the criminal fine in Germany developed into the most important criminal sanction. It excludes only heavy crimes, usually crimes for which the maximum prison sentence is higher than 5 years.

One critique against this development is that a prison sentence guaranties that the individual offender is punished and deterred. A fine cannot guarantee this, if for instance a father pays for his son. To some extent this can however be alleviated, for instance by prohibiting companies to pay fines for their managers. And the finding that prison sentences often lead the offender into a criminal milieu which increases the probability of a repeat offence, dwarfs this critique. Monetary fines seem to avoid this more than imprisonment. They do not estrange the offender from friends and family. In Germany the probability of a repeat offence after a prison sentence without probation is about 70 per cent, whereas it is about 30 per cent after a criminal fine.[7] This development in the direction of criminal fines, which made it possible to shut down many prisons is fully in line with economic reasoning and avoids the problems of shifting the deterrence function to the civil law, because the defendant remains protected by the criminal procedure.

[6] Section 40 of the German Criminal Code (StGB).

[7] A comprehensive research arrives at the following figures. For juvenile delinquents the quota of repeat offences is 36.6 per cent after a criminal fine and 78.8 per cent after a prison fine without probation. For adults the equivalent numbers are 29.8 per cent and 55 per cent. (Jehle et al. 2003, p. 43).

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