

Designing regulatory institutions

Western models of regulation have a growing influence in developing countries. Promoted by the World Bank and IMF, they are assumed to lead to economic growth. But many problems arise when attempts are made to put these imported models into practice - strategies designed for a Western context often do not work well when transplanted to different economic, social and political cultures. Although this is well recognised the most common response is to simply carry on 'as well as possible' in the circumstances. We ask whether a more creative response might produce better results.

Research indicates that a country's legal system is related to its economic growth. However this does not imply that successful legal systems must conform to a Western model. It is true that some basic components seem to be important everywhere. These include the protection of property rights, institutions that cannot easily be subverted by powerful individuals, an independent judiciary and stability of rule-making. But there are also variations which can be effective in their own contexts. For instance disputes need not always be settled through formal channels. In China and East Asia, for example, informal negotiation using negotiators is common and may well have contributed to economic success.

Background

The kinds of legal reforms promoted for less developed countries have varied enormously over time. Early attempts to transplant liberal democratic Western legal models were not successful in promoting economic growth. Reformers came to understand that the situation was

more complex than they had originally assumed and that the cultural and political environment had to be taken into account. The second wave of reforms focused on enabling strong state intervention. It was hoped that such a state could foster development that was less dependent on external forces. Some also hoped that resources would be distributed more equitably. But again, in practice, the promised economic growth did not materialise and, far from a fairer distribution of resources, it seemed that the power of the political and bureaucratic elite was enhanced.

The 'third wave' of reforms followed the collapse of the Soviet Union and coincided with the rise of privatisation and deregulation in the West.

Economic crisis meant less developed countries became more dependent on donors - for whom legal reform was important for two main reasons. Firstly, the new focus on regenerating the private sector meant a new role for the state, so a supporting legal framework was needed. Secondly, 'good governance' was increasingly

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being invoked as a prerequisite for speedy economic growth. Since donors are always reluctant to get involved directly in politics they tend to focus instead on legal and judicial reform.

Most reformers currently promote a number of basic principles. Firstly, government itself must obey the law. In general the rules should be reasonably certain, clear and stable. They should be published so that everyone can know what they are and there must be ways of ensuring that they are applied fairly to all. An independent judiciary must operate without unreasonable delay in its proceedings and judicial sanctions must be effective.

Problems of policy transfer
Of course in practice it is very difficult to assess whether a particular system is 'fair' or 'just', especially as ideas about justice and fairness are contested. However this has not stopped many donors from advocating major reforms to developing country legal systems. These often involve trying to improve institutions such as courts, judges and law enforcers and trying to ensure that government institutions obey the law. However many such efforts fail to a greater or lesser extent. Reforms may be achieved on paper but what goes on in the real world often remains much the same. Political interference, a lack of transparency in decision-making and corruption often mean courts continue to be weak.

Bureaucratic failure is often blamed. In other words it is claimed that senior bureaucrats are so close to the ruling elite that there is no clear dividing line between politics and bureaucracy. Alternatively it may be suggested that it suits the ruling elite if reforms exist only on paper.

But there are other reasons why reforms may fail. One is a relative lack of resources such as staff and information technology. Lower education levels may affect both the decision-making ability of officials and the likelihood that the general public will be able to contribute to enforcement. Although rule-making may be cheap, implementation is expensive and labour intensive. So might more effort be put into designing rules that are relatively cheap and easy to enforce?

However, even if all the necessary institutions had been set up and there was no lack of resources, it would be still be unreasonable to expect people to behave in the same ways as their counterparts in the West. In some countries even the idea of invoking the law in one's everyday life would be strange to most people. And traditional cultures may use very different models of rule-making and enforcement. For example lawyers may be much less important than mediators, wise men or religious authority. Society may be strongly hierarchical, family groups (rather than individuals) may be seen as the building blocks of society, customs may vary greatly from one area to another, decision-makers may have a lot of discretion and so on. Attempts to impose Western legal systems in such contexts are not likely to succeed. Instead we should give more thought as to how systems can be designed to fit their particular contexts.

Responding to difference
Reformers often note such resource constraints and cultural differences but carry on regardless with an unchanged strategy. Might a more creative response be possible? It should be noted that, in many countries where traditional law has been strong, it has not been static but has adapted to changing political and economic circumstances. It would be helpful if regulatory regimes could become identified with, or internalised by, the community. Where regulatory goals are compatible with community norms they will be easier (and therefore cheaper) to enforce.

But there may still be problems in applying sanctions where many lawbreakers simply cannot afford to pay fines. Imprisoning people for fairly minor crimes is obviously an unattractive option and not to be recommended. If social norms support the regulations then social disapproval and stigma may be effective deterrents. But in some contexts it may be worth considering introducing 'vicarious liability'. In other words, if the offender cannot pay the fine is there someone else (who can) who might reasonably be held responsible? This method is familiar in Western business law where companies can be held responsible for acts of their employees. In a developing country context it might be considered appropriate for a member

of the offender's extended family or community to be held responsible for his or her rule breaking.

In recent years Western styles of regulation have tended to move away from detailed rules towards stating more general principles. This then gives enforcers more discretion to consider the particular circumstances when making their decisions. In less developed countries this might also seem an attractive option, especially given the high levels of discretion often found in traditional law. But where regulations are not integrated with traditional law problems may arise. Firstly, low general levels of education may mean that the necessary knowledge and expertise are in short supply. And secondly, exercising discretion provides greater opportunities for corruption.

We now go on to look at two specific areas of regulatory policy in developing countries – licensing and corruption. After first considering current practice and problems we look at some possibilities for change.

Licensing – the public interest
All governments need some way of ensuring that customers are protected from unscrupulous enterprises offering unsafe products and services. In Western countries the usual method is to set standards and require all businesses to comply with them. Regulatory agencies then ensure standards are being met through inspections which may be random or targeted, sometimes in response to complaints from customers.

But there is another way of providing customer protection - businesses may be required to obtain a licence before they start trading. This option is much more expensive and in industrialised countries tends to be reserved for high risk sectors. However in less developed countries licensing is much more widely used. Why is this, given it is so much more expensive?

How is licensing usually justified?
Sometimes the quality of goods or services cannot be easily judged before they are bought. To help consumers make the right choice, suppliers can be made to provide information. But it may be that governments do not think people are capable of understanding the information and acting in their own

best interests. And of course where education levels are lower people are likely to be less able to process complex information. So, where this is the case, governments may feel justified in preventing enterprises that will not meet minimum standards from starting trading. But can this really explain why the costly process of licensing is so widespread?

If the very high costs involved in scrutinising every supplier's licence application are to be justified then there must be some compelling reason why the alternative of checking up on businesses while they are operating is unacceptable. The usual argument put forward is that less developed countries are not capable of setting up and operating such monitoring systems; they have neither the resources nor a general public willing and able to make complaints.

At first sight these appear powerful arguments but on closer examination they are perhaps less so. Firstly they assume that licensing is a better use of scarce resources than investing in monitoring and policing systems. Is this true? Although licensing may indeed prevent some would be rogue traders from starting to operate, others may simply decide to start up anyway, illegally, without a licence. Evidence suggests there are many unlicensed traders to be found in the informal economies of some countries. So policing remains necessary. Indeed it is also needed in order to check that licensed businesses are operating according to the terms of their licence. And if an applicant is to be refused a licence then evidence will be needed to demonstrate why they are unsuitable.

In fact it is clear that, in less developed countries, licensing has another significant purpose. Indeed this is sometimes its main purpose. It is an important source of revenue, particularly for local government. To achieve this the fees payable are set at levels above those needed to cover administrative costs. Such a way of raising money is easier to organise than conventional taxation. And it may well be that traders are less resistant to paying taxes when they are disguised as fees.

But the higher fees are set the more likely that an enterprise will decide to avoid the whole process. So, if

licenses are not solely a money-raising device but are also intended for consumer protection, then higher fees mean more consumers will remain unprotected. Also, if licensing is to remain an attractive alternative to taxation, then fees will probably be flat rate. This will not be compatible with fiscal policy which requires payments to relate to, say, the number of people an enterprise employs or its turnover.

Licensing – private interests
Do politicians have an interest in maintaining control over who enters the market? Widespread regulation of market entry implies the government has a lot of control over the economy as a whole. Historically, rulers have extended their power by keeping control of key industries. That some politicians are reluctant to relinquish such power may partly explain why entry controls such as licensing remain so popular.

And what about public officials? Do they also have an interest in maintaining licensing systems? Such systems are labour intensive so officials may have an incentive to protect their jobs and career opportunities. Furthermore, when issuing a licence calls for some discretion on the part of the issuer, they may have opportunities to extract bribes from applicants.

It would seem that, in the public interest, it would be better if many licensing systems were dismantled and replaced by monitoring and policing regimes. However our analysis of private interests indicates that this might well be difficult to achieve.

Corruption – the usual remedies
Corruption is a big problem for all regulatory systems and it is not difficult to see why. Regulatory officials make decisions that can enrich or impoverish others, not only when they issue contracts and licences, with their obvious profit-making potential, but also when they interpret and enforce standards. They may interpret standards in a prejudiced way and, when they catch people who are breaching them, they have the power to choose whether or not to punish them. When grants are negotiated or behaviour scrutinised for compliance, the necessary face to face contact provides further opportunities for bribery.

Because corruption seriously affects economic development some governments have launched wide-ranging assaults on it and some, such as in Singapore and Hong Kong, are generally considered to have been successful. But their experience shows that political will is essential for success. Where this does not exist it will be necessary to accept that corruption is to some extent inevitable and to focus on reducing the damage it does, rather than eliminating, it. When working out anti-corruption strategies it is important to be sensitive to how the local political and cultural environment differs from that of the industrialised countries where most such strategies originate.

For example, popular Western strategies for reforming bureaucracies include depoliticising the civil service, removing conflicts of interests, recruiting better staff, insisting on clear procedures and reasoned decision-making, better internal auditing and monitoring, and extending external powers of appeal and review. But these sorts of changes need a strong and impartial judiciary, a proactive citizenry, adequate resources and effective implementation. In many less developed countries this would require major cultural changes and the costs would simply be too great.

However some more modest measures can be cost effective. In South Korea, for example, investing in information technology to provide public information and automatically record transactions has made decision-making more transparent. It has also enabled some transactions to be carried out electronically, so reducing face to face contact. Computerising the Philippines customs service has reduced the time taken to process cargoes from about eight days to two hours and presumably significantly reduced corruption too.

How should regulators decide on the penalties for corruption? Usually making the penalty fit the crime involves ensuring that the costs to criminals outweigh the benefits, after taking into account the likelihood of detection. In the case of corruption this might suggest relating the size of the penalty to the size of the bribe. However so much corruption goes undetected that allowing for this would result in penalties so severe that most courts would refuse to apply them.

Some suggest that creating a special anti-corruption agency, independent from the police, can be effective and indeed Singapore seems to have had some success with this method. However, where the political will to push through wide-ranging reform is lacking, creating a separate agency can backfire by increasing the opportunities for corruption.

Limiting corruption – alternative methods
Conventional anti-corruption strategies as outlined above are likely to be less effective precisely where the problem is worst i.e. where the criminal justice and law enforcement systems are themselves corrupt, where resources are scarce and the political will is lacking. An alternative is to consider how institutional arrangements can be designed so as to limit opportunities for corruption or make it less profitable.

Some such reforms might mirror what is happening in industrialised countries. Others would not or would be ambiguous. Take decentralisation for example. Does this help the fight against corruption? Some commentators say it should, arguing that when decisions are made at local level they are more transparent, making corruption harder to hide. On the other hand, others suggest that when the regulatory process is centralised, paying a single (and perhaps more effective bribe) to a more powerful official may have less negative impact on the overall economy. Might this help explain the difference between Indonesia and India's economic performance? Both countries suffer from similar levels of corruption but in the more economically successful Indonesia it is centralised. In India, in contrast, bribing takes place at many different levels of bureaucracy.

Similarly we can ask how competition between different regulatory agencies affects corruption. Some evidence suggests that such competition can reduce it. This seems to be the case in the US, for example, where local, state and federal agencies are all

involved in controlling illegal drugs. On the other hand, if competition leads to more bureaucracy, corruption could well be expected to increase.

What other strategies might help? Perhaps it would be helpful if committees made decisions rather than individuals. Regularly moving bureaucrats between different offices could also reduce their opportunities for corruption. Sometimes simply reducing the amount of regulation can be effective - legalising off-course betting in Hong Kong had this effect for example. However it is unwise to generalise from such a relatively peripheral topic to critically important issues such as health and safety or environmental protection. While unnecessary regulation is certainly unhelpful, of course it does not follow that less is always better. Another useful strategy is to use administrative sanctions rather than criminal courts where possible. Evidence suggests that bribes get much larger when courts are involved in law enforcement.

The need to contain corruption also suggests strategies that are very different from those preferred in the West. For example, in industrialised countries recent reforms have tended to increase the amount of discretion regulatory agencies have in interpreting and implementing the rules. Clearly this helps them react more sensitively to the particular circumstances of the case. But of course it also provides more opportunities for corruption. Therefore in some countries clear and unambiguous rules which offer less room to manoeuvre may be more effective.

Similarly, in Western contexts, there has been a move away from formal rules towards the issuing of guidelines. This recognises that business people themselves may often be in a better position than regulators to work out how to meet regulatory goals at least cost. But similar moves in some developing countries have been unsuccessful. People have found themselves

confronted with many specific rules and procedures while knowing that these may not be enforced in practice. In fact preferable informal rules will prevail for the favoured few. Those unwilling to pay the costs of admission to this favoured circle risk being penalised through the (often unreasonable) formal rules. What seems to be needed here then are fewer and simpler formal rules rather than informal rules.

Consultation is another area where a different approach might be useful. In the West, those who will be subject to regulation are increasingly encouraged to get involved in drawing up the rules. There are obvious benefits in terms of information flows, transparency and accountability. But of course direct access to regulatory officials also increases opportunities for corruption. In the US attempts to deal with this have included making all private communications and records of all private meetings available for public scrutiny. But the necessary policing and record keeping may not be possible everywhere. In which case cutting down on consultation may be an effective, if unpalatable, alternative.

To sum up, we have argued that too much effort has been put into struggling to implement Western models of regulation against the prevailing cultural, social and political circumstances. Rather than carrying on regardless we suggest that reformers should explore how regulatory regimes can be made more compatible with their contexts since, if they could be internalized as social norms, community disapproval might well be a more effective deterrent than imposed sanctions.

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This CRC Policy Brief draws heavily on the CRC Working Paper below:

No 119 Ogus, A. *Towards Appropriate Institutional Arrangements for Regulation in Less Developed Countries* 2005

which is available on the CRC web site at:

www.competition-regulation.org.uk/publications/working_papers/

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