

Centre on Regulation and Competition

WORKING PAPER SERIES

**Paper No. 91**

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DEVELOPING COUNTRIES:  
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**Qing Zhang and Anthony Ogus,  
University of Manchester**

**January 2005**

ISBN: 1-904056-90-3

Further details:  
Published by: Centre Secretary  
Centre on Regulation and Competition,  
Institute for Development Policy and Management, University of Manchester,  
Harold Hankins Building, Precinct Centre, Oxford Road, Manchester M13 9QH, UK  
Tel: +44-161 275 2798 Fax: +44-161 275 0808  
Email: [crc@manchester.ac.uk](mailto:crc@manchester.ac.uk) Web: [www.competition-regulation.org.uk](http://www.competition-regulation.org.uk)

# **Licensing Procedures in Developing Countries: Should They Be Part of the Set-up Process?†**

**Qing Zhang\* and Anthony Ogus\*\***

## ***Abstract***

Surveys have shown that, in general, developing countries tend to regulate the set-up processes for firms more intensively than developed countries. In particular, while many developing countries tend to integrate licensing requirements in the set-up process ("set-up licensing"), the more developed countries generally use licensing procedures independent of the set-up process ("independent licensing"). Set-up licensing requirements must be met before an enterprise can lawfully exist and operate in any respect. In contrast, an independent licensing system merely requires authorisation for the particular activities that are to be controlled, and this does not affect the right of the firm to exist and engage in other business activities. More importantly, set-up licensing may impose more compliance costs on entrepreneurs, more administrative costs on officials and more welfare losses on consumers than independent licensing. In this paper we explore the distinction to see whether the widespread preference for set-up licensing in developing countries can be justified on public interest grounds, or at least explained on private interest grounds.

**Keywords:** Licensing Procedures, Developing Countries, Set-up Process, Set-up Licensing, Independent Licensing

## **I INTRODUCTION**

Business set-up process refers to all procedures that an entrepreneur needs to carry out to begin legally operating a firm involved in any industrial or commercial activity. As revealed in a World Bank study (2004a), developing countries tend to regulate such set-up processes for firms more intensively than developed countries and the social benefits generated by such heavier regulation are by no means clear. There may then be arguments for developing countries relaxing these regimes provided that the related public interest regulatory functions are not jeopardised.

There are two main types of regulatory controls in the set-up process: registration and licensing (Ogus and Zhang, 2005). Registration requires the actor to furnish the public

authority with specific information prior to being allowed lawfully to engage in the business activity. The officials merely accept the information and keep it on file; they do not have to determine whether applicants meet substantive conditions for engaging in the activity. In contrast, licensing is intended to test the suitability of applicants and/or their circumstances against substantive conditions and involves some degree of decision-making discretion.

When a licensing requirement constitutes part of the set-up process, it must be met before an enterprise can lawfully exist and operate in any respect. Usually, there is at least one procedure in the set-up process to verify that the licensing requirement has been met and thus the authorities are satisfied with the quality of market participants. In contrast, if a licensing requirement is independent of the set-up process, it merely requires authorisation for the particular activities that are to be controlled, and this does not affect the right of the firm to exist and engage in other business activities (Morisset and Neso, 2002). Where the licensing procedure is integrated in the set-up process, we call it "set-up licensing" (SL); where it is independent of the set-up process, we call it "independent licensing" (IL).

SL regimes tend to be more widely used in developing countries; IL regimes in developed countries. SL procedures can themselves be classified into two kinds: GSL (general set-up licensing) and SSL (sectoral set-up licensing) (Spall and Szerb, 2004). GSL refers to a licensing requirement imposed on *all* entrepreneurs before they can establish any kind of businesses. Some form of GSL regime is imposed in many developing countries (Devas and Kelly, 2001), typically for zoning approval, environmental impact certificates, and approvals relating to working safety, building, fire, sanitation, hygiene, and minimal capital requirements (Djankov, 2002). For example, a World Bank (2004b) database reveals that in Gaborone City, Botswana, as part of the application procedure for a trading or industrial licence, all firms must have their premises inspected by the health and environmental authorities to ensure compliance with minimum standards.

In contrast, SSL applies only to those entrepreneurs wishing to engage in specific sector industries. It requires entrepreneurs to obtain an approval for a sector business from a sector licensing authority before they complete the set-up procedure. Although not identified as such in the World Bank study, SSL regimes are often used in developing countries to regulate specific business sectors. Take the case of Costa Rica. All entrepreneurs, in whatever business, must go through at least six procedures, dealing sequentially with the Commercial Registry, Tax Authority, National Insurance Institute, Social Security Institute,

Ministry of Health and Municipality (Jansson and Chalmers, 2001). But, in addition, an entrepreneur wishing to operate, for example, a restaurant must comply with the SSL requirement of obtaining a clearance from the fire department before registering with the Ministry of Health. In the Philippines, SSL regimes govern, notably, retailers, wholesalers, and manufacturers of veterinary products and of pharmaceutical and food products feeds and veterinary clinics, custom and real estate brokers, auto, electronic and telecommunication repair shops, and vocational schools (Legaspi, 2004).

In this paper we explore the distinction of SL and IL regime to see whether SL licensing in developing countries can be justified on public interest grounds, or at least explained on private interest grounds. In section II, we contrast SL regimes with IL regimes in terms of costs imposed on the officials, entrepreneurs and consumers. In section III, we examine possible public interest justifications for preferring GSL and/or SSL to IL. This is complemented in section IV by a consideration of possible private interest explanations for SL regimes, exploring who can obtain rents from such systems. In Section VI, we reach some brief, general conclusions.

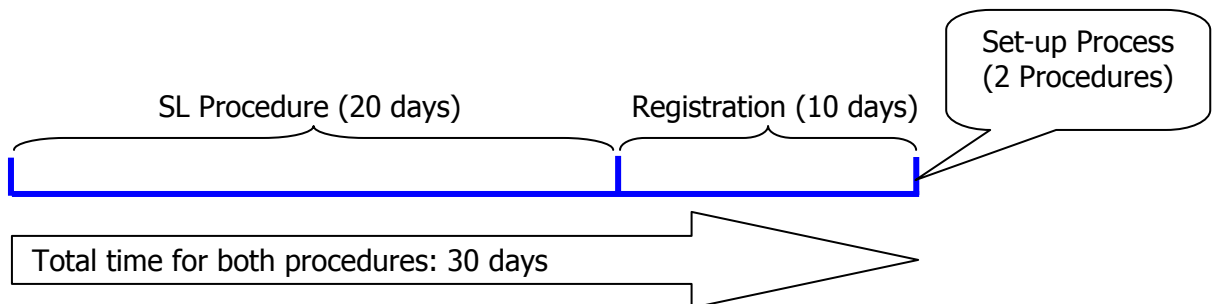
## **II A COST COMPARISON OF SET-UP LICENSING AND INDEPENDENT LICENSING REGIMES**

There are important differences between the SL and IL procedures. Since IL is independent from the set-up process, entrepreneurs can choose to engage in the IL procedure before, after, or concurrently with the set-up process. By way of example, take the different licensing procedures for the manufacture of pharmaceutical products in the People's Republic of China, where SL prevails, and contrast it with the United Kingdom where IL is used. Let us assume that entrepreneurs decide to establish a limited liability company for this purpose. In China, the entrepreneurs cannot register with the Industry and Commerce Administration for the limited liability company unless they have first obtained a drug manufacturer's licence from a branch of the State Food and Drug Administration at the provincial level (Pharmaceutical Administration Act, 2001). In the United Kingdom, the procedure of registering with Company House for the same purpose is independent of the procedure for obtaining a drug manufacturer's licence (Davies, 2003). Entrepreneurs can decide when to register with Company House and when to apply for the drug manufacturer's licence.

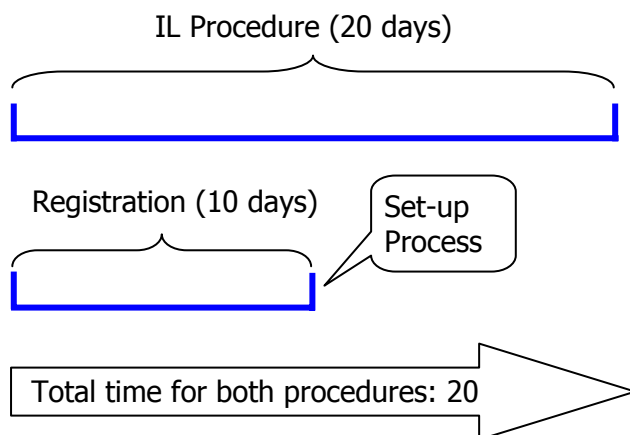
It is important to compare SL and IL regimes in relation to administrative costs, compliance costs and other, indirect, costs incurred by, respectively, officials, entrepreneurs and consumers. To facilitate our analysis, we choose a simplified example, as illustrated in Diagram 1. We assume that, under a SL regime, the set-up process consists merely of two consecutive procedures. One is the SL procedure (taking 20 days); the other is a registration procedure (taking 10 days), during which the responsible agency checks to ensure that a copy of the set-up licence has been supplied, but has no discretion to reject the registration application once the copy has been supplied. If, however, licensing is required under an IL regime, an entrepreneur may choose to engage in the IL procedure concurrently with the registration process, which is also a set-up process. Then we have two parallel procedures: one is the IL procedure (taking 20 days); the other is the registration procedure (taking 10 days). For convenience, we assume that, in respect of matters other than procedure, the substantive conditions under the two systems are identical.

**Diagram 1: Zhang and Ogus**

**SL Regime:**



**IL Regime:**



The administrative costs incurred by officials include mainly the costs of processing the applications, inspecting and monitoring the entrepreneurs (including detecting and apprehending unlicensed entrepreneurs). Under the SL regime, the costs of processing the applications can be somewhat greater than those under the IL regime, because the officials under the SL regime have the additional task of checking that a copy of the licence has been submitted.

The compliance costs to entrepreneurs include direct administrative costs in making their application, other capital investment in meeting both registration conditions and licensing conditions and lost profits resulting from the length of the application process (e.g. losses from delay and failure in marketing new products). Entrepreneurs incur different compliance costs under the two systems. If the SL regime is adopted, it takes entrepreneurs at least 30 days to complete the SL and registration procedures before they can lawfully begin the business. In contrast, under the IL regime, this can be done within 20 days. This shorter period generates not only a saving of direct expenditure, but also an increase in potential profits that can be earned.

As regards indirect consumers' costs, these mainly include any welfare losses arising from barriers to competition caused by the above regulatory requirements. For example, the length of the application process for the license and registration certificates may delay the marketing of new products. SL regime may therefore generate greater consumers' losses than the IL regime, because of the additional delay or even failure in making the products available to them.

Admittedly, the distinction between the SL and IL regimes will sometimes be small if entrepreneurs wish to engage in other, unregulated business activity, in addition to that subject to the SL requirement. For example, in China, entrepreneurs can begin to operate other unregulated activity by registering the businesses with the Industry and Commerce Administration, while their application for a set-up licence from a sector agency is being considered. However, under the SL regime, even if approval is obtained from the sector agency, they will not be able to begin the sector business until they have re-registered the licensed business with the Industry and Commerce Administration (Registration Regulation of Business Scope of Enterprises, 2004). The re-registration also costs entrepreneurs time and money.

### **III PUBLIC INTEREST ANALYSIS OF KEY FEATURES IN SET-UP LICENSING REGIMES**

If, as was suggested in the last section, SL regimes give rise to higher costs than IL regimes, why should they be preferred to IL? In this section, we consider a range of possible public interest justifications for the two types of SL regimes, GSL and SSL, relative to IL regimes.

#### **Justifications for Preferring General Set-up Licensing to Independent Licensing Regimes?**

A public interest analysis of GSL regimes mainly involves choosing between an *ex ante* licensing requirement and regulation which does not control entry but rather is applied *ex post*, including information regulation (mandatory disclose) and/or on-going performance standards (Ogus and Zhang, 2005). Few GSL regimes can be justified on public interest grounds since it is almost impossible to identify a licensing requirement appropriate for all sectors, all firms and all activities. To elaborate, the condition for the licensing system to be justified is  $C < PL$  where  $C$  denotes costs additional to those that would have been incurred with an *ex post* system, notably the costs of *ex ante* scrutiny required for the licensing process,  $P$  represents the probability of the losses occurring in the absence of such scrutiny and  $L$  is the losses which the scrutiny would prevent.

In the light of this reasoning, a licensing requirement can be justified only in some specific business sectors where there is a high value for  $P$  and/or for  $L$ . For example, a new enterprise may decide to put its business place in a leased office of a building that has passed all fire safety inspections before its completion, and the business in that office involves no significant fire risk; it therefore makes no sense to oblige the new enterprise's office to undergo another fire inspection unless a new decoration or alteration generates significant fire risks. An efficient regulatory system would apply the fire safety licensing requirement only to those business activities with high fire risks, e.g. running a theatre.

To take this analysis further, we must consider the relative capacity of *ex ante* licensing regimes and their *ex post* alternatives to deter activities involving substantial risks. In many cases, even if, for example, there may be substantial health risks caused by employees, usually they cannot be effectively prevented at an *ex ante* stage; reliance must be had on *ex post* control e.g. on-going health examinations to monitor the employees' health condition.

Let us examine another popular GSL example involving the minimal capital requirement imposed on firms. It has been suggested that this requirement aims to protect creditors from the opportunism of some shareholders, especially where they might exploit limited liability (Pistor et al, 2002). However, it is doubtful whether the *ex ante* minimal capital requirement efficiently meets this aim. Opportunist shareholders can easily evade the requirement if they are determined to do so (Jenkins Committees, 1962). For example, they can simply borrow money to meet the minimal capital requirement at the time of registration and then repay it. Moreover, the high compliance costs caused by this requirement can make the corporate form less attractive for small enterprises (Freedman, 1994) or induce them to misrepresent finances to obtain registration. It has been reported that of 201 enterprises inspected by the Shenzhen Municipal Industry and Commerce Bureau (China) in April 1998, at least 130 had forged their investment verification certificate, in order to meet the minimal capital requirement (Sun, 2003). If the market mechanism or *ex post* remedies, whether civil remedies or criminal sanctions, are able to prevent or reduce this opportunism at less cost, then the minimal capital requirement as a licensing condition might not be justified. The same reasoning can also be applied to other GSL requirements of public safety and health, such as those imposed in Gaborone City, Botswana.

## **Justifications for Preferring Sectoral Set-up Licensing to Independent Licensing Regime?**

### ***Improving Compliance?***

For convenience, we assume that, in terms of generating benefits, the SSL and IL regimes would be equally competent in meeting their regulatory aims, for example, reducing health risks, if there were perfect compliance. However, many developing countries are often afflicted by weak regulatory enforcement capacity and the informal economy is typically large and growing (Schneider, 2002). The average size of the informal economy, as a percentage of official GNI in the year 2000, in developing countries, was 41 per cent, in transition countries 38 per cent and in OECD countries 18 per cent (Schneider, 2002). There is evidence of large numbers of unlicensed traders operating in the informal economy in some countries (Suhir and Kovach, 2003). For example, it is estimated that, there are 30,000-40,000 unlicensed taxis alongside 67,000 licensed taxis in Beijing (Yang, 2004). As a solution, better regulatory enforcement is often advocated. According to the familiar Becker (1968) model, enforcement may be problematic if potential offenders perceive that formal sanctions and other losses incurred as a consequence of apprehension and condemnation



for regulatory contraventions, when discounted by the probability of apprehension and determination of liability, are exceeded by the utility they derive from the contravention. The condition can be expressed by the formula  $PD < U$ , where  $P$  is the potential offender's perceived probability of apprehension and condemnation by a public agency,  $D$  represents the costs imposed on the offender, and  $U$  denotes the latter's perceived own benefits derived from the contravention.

When a licensing requirement is designed as set-up licensing, its enforcement can, at least in theory, be verified by one agency responsible for subsequent procedures. It might be argued that, in comparison with an IL regime, using an SSL system can significantly enhance the value of  $P$ , the probability of detecting the unlicensed activities;<sup>1</sup> and perhaps the argument has influenced regulatory policy in some countries. However, further consideration suggests that this compliance argument is somewhat problematic. It seemingly assumes that entrepreneurs always complete the set-up process before engaging in any business, which is often not true in practice. The verification procedure designed for SSL regimes will play no role if an entrepreneur decides not to engage in the set-up process, preferring simply to join the underground economy. More entrepreneurs are likely to behave in this way under an SSL regime than under an IL regime, because of the higher compliance costs incurred. Thus the benefits of participating in the informal economy, denoted as  $U$ , are increased substantially since more costs can be saved by avoiding the set-up process in an SSL regime. According to a survey in 2002, in Shenzhen city, China, there were more than 8,000 business proprietors who operated in the informal economy, without a registration certificate (Wang, 2004 who argues that one major reason for this phenomenon was the existence of SSL regimes).

Let us return to the simplified example in diagram 1 and assume there are a number of applicants wishing to operate a sector business subject to the licensing control. Under an SSL regime, applicants have, in theory, three options. Some may go through the whole set-up process, including the SSL licensing and registration procedures (option SSL/1). Some may complete the SSL procedure but not the registration procedure (option SSL/2). However, it is reasonable to assume that an applicant will complete registration once the licensing application has been approved, since the marginal additional costs of doing this are low and the marginal benefits (e.g. lawfully engaging in business) may be high. Finally, due to high entry costs, some applicants may decide not to engage in any procedure and simply operate in the informal economy; or their application for a set-up licence is rejected with the

same outcome (option SSL/3). Analogously, under an IL regime, some applicants may complete both the IL and registration procedures (option IL/1); some may complete the registration procedure but not the IL procedure (option IL/2); some may finish the IL procedure but fail to register (option IL/3 - we assume that this will not be chosen because of the low marginal costs of registration and its high marginal benefits); and some will not engage in any procedure but simply operate in the informal economy (option IL/4).

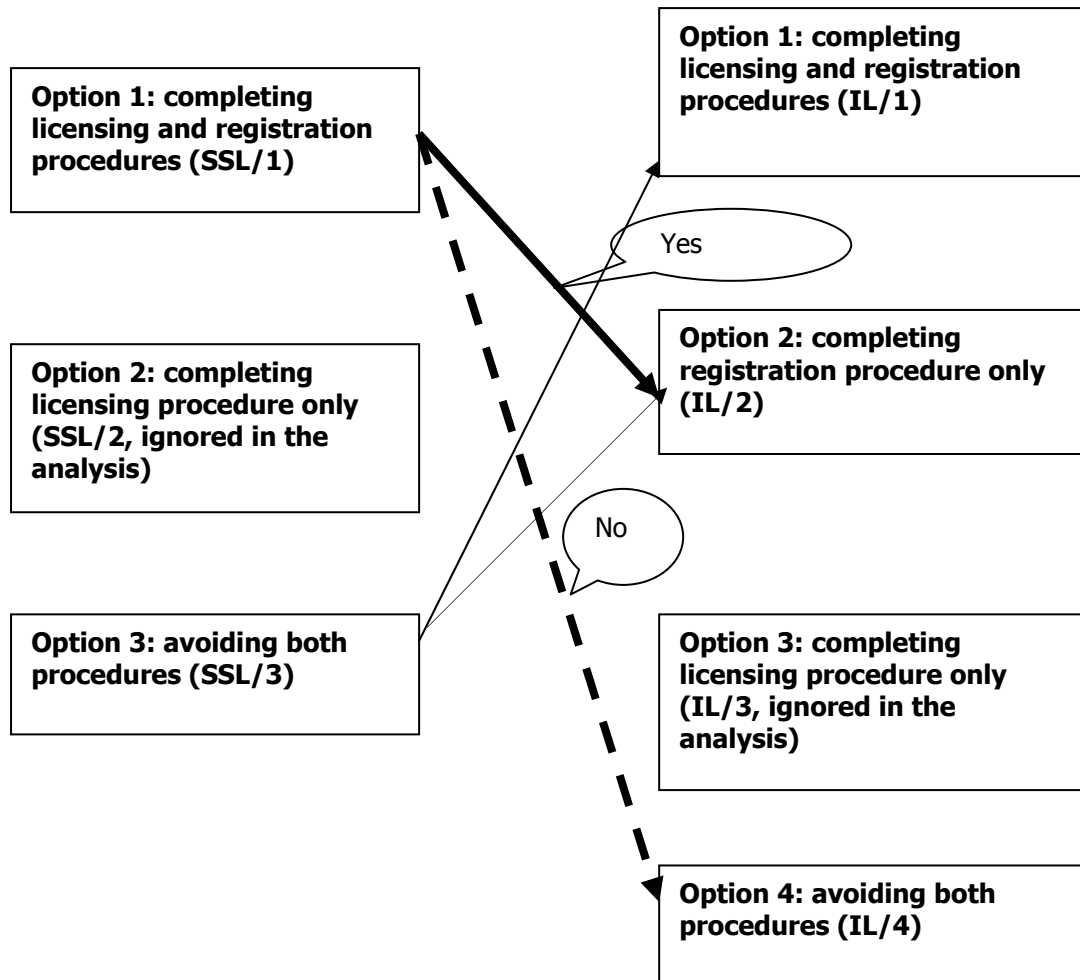
We now consider whether fewer applicants are likely to complete both licensing and registration procedures under an IL regime compared to an SSL regime. We use Diagram 2 (overleaf) to illustrate our analysis. Some applicants choosing option SSL/3 (avoiding both licensing and registration procedures) would probably decide not to choose option IL/4 (avoiding both procedures) under an IL regime, but rather shift to option IL/1 or IL/2. This is because the benefits to those applicants of avoiding both licensing and registration procedures under an IL regime (saved compliance costs) are less than under an SSL regime. The shift might lead to better regulatory compliance under an IL regime than under an SSL regime. On the other hand, some applicants choosing option SSL/1 would probably decide not to comply with the regulatory requirement under the IL regime, since, to them, the perceived probability of apprehending their contraventions is reduced, owing to the abolition of the verification procedure.

At first glance, it might seem that, under the IL regime, some applicants are likely to complete the registration procedure without attempting to satisfy the licensing requirement; and that this cannot happen under a SSL regime. This would mean that those applicants choosing option SSL/1 now have a new option, IL/2. However, there are arguments why these applicants might not shift to the option IL/4: avoiding both procedures is likely to generate fewer benefits (expressed as a smaller **U** figure) under an IL regime compared to an SSL regime; but the perceived probability of apprehension and consequent costs to the offender (respectively, **P** and **D**), are unlikely to differ as between the two licensing regimes (we assume if those avoiding both requirements are detected by one agency, licensing or registration, for one contravention, notification will lead readily to detection of the other contravention).

**Diagram 2: Zhang and Ogus**

**Three Options under SSL Regime**

**Four Options under IL regime:**



Whether SSL regimes can generate better regulatory compliance than IL regimes depends ultimately on a balance between two shifts, that is, whether the number of applicants shifting from option SSL/1 to option IL/2 exceeds the number of applicants shifting from option SSL/3 to option IL/1. If the answer is negative, then the argument for enhanced compliance by SSL regimes cannot be sustained. Moreover, as we will now demonstrate, regulatory authorities can adopt some measures to reduce the number of applicants shifting from option SSL/1 to option IL/2, and to increase the number shifting from option SSL/3 to option IL/1. By such means regulatory compliance under an IL regime should be no worse than that under an SSL regime.

The Becker model can be used to design such measures. The action should generate a reduction in the applicants' perceived benefits from choosing option IL/2, expressed as **U** in the model, and an increase in the perceived probability of apprehension and consequent costs to the offender choosing the option IL/2 (respectively **P** and **D**). The value of **U** is determined mainly by two variables: the potential offenders' perceived savings from avoiding the IL procedure (equivalent to the perceived costs that they would have incurred for securing the independent licence), minus their lost profits as some consumers, recognising that the business is unlicensed, refuse to purchase the goods or services. The value of **P** depends largely on the resources of the licensing agency available for policing and monitoring. And the value of **D** can be increased by imposing stricter punishments on offenders.

In practice, there are a number of strategies to achieve these goals for an IL regime. First, the registration agency can be required to notify the licensing agency when it detects some unlicensed business activity, thus increasing **P**, or, for the same purpose, more resources can be made available for policing and monitoring. Second, policymakers can raise the value of **D** in the IL regime by imposing stricter punishments on those applicants who merely complete registration. For example, the registration certificates of these businesses could be revoked once the unlicensed activity is discovered. Third, some education campaigns could be organised to notify consumers of the shift from SSL to IL regimes. The consumers would have to be made aware that a registration certificate under the IL regime does not guarantee that the holder complies with the substantive conditions of the licensing criteria. This might effectively reduce consumers' purchases from the unlicensed businesses and thus reduce the business profits of the latter. Fourth, the measures reducing **U** and increasing **P** and **D** figure for applicants choosing option IL/2 may also result in a corresponding reduction of perceived benefits, and increase the perceived probability of apprehension and consequent costs, for those applicants choosing option IL/4. The consequence may be more applicants choosing option IL/1.

Of course, all these policies would increase administrative costs and even consumer costs (receiving information from officials). If any of these policies are necessary to ensure that regulatory compliance under IL regimes does not compare unfavourably with that under SSL regimes, then policy-makers have to make another trade-off. Only if the administrative costs incurred for the suggested policies exceed the additional compliance and other costs falling mainly on consumers and officials under SSL regimes (compared with the IL regimes) can

SSL regimes be justified on public interest compliance grounds. Without precise information on this, it is difficult to draw hard conclusions from the analysis.

### ***Saving Compliance Costs on Other Procedures?***

It might be argued that, compared with IL regimes, SSL regimes are able to reduce compliance costs arising from other procedures in the set-up process. If entrepreneurs fail to obtain an SSL licence, they will not incur further compliance costs from subsequent procedures. In contrast, under an IL regime, they may well have completed the set-up process and paid all related compliance costs before being informed of the failure of the licensing application, at least if the licensing procedures take longer than the set-up process. As shown in diagram 1, under the SSL regime, entrepreneurs will not incur the costs of registration (at least the administrative costs of making the application) once they are informed of the unsuccessful licensing application. But under the IL regime, they might already, by this stage, have incurred the compliance costs of registration. In the light of this, it is better to slot in the more complex licensing procedure (often with less predictable outcomes) in the earlier stages of the set-up process. If the licensing application is not successful, then it makes no sense to go through subsequent procedures. This argument would be particularly strong if the compliance costs incurred for other procedures are substantial, if the rate of rejection of licensing applications is high, and if the entrepreneur only wants to operate the business which is subject to the licensing requirement.<sup>2</sup>

However, the above argument ignores the fact that entrepreneurs can make their own choices to save compliance costs arising under IL regimes. If an entrepreneur is not confident about the success of the application and the compliance costs for the other procedures are high, the decision can be made not to engage in the other procedures until there is information on the success of the licensing application. In theory, at least, the IL regime allows applicants to decide how to minimise compliance costs, notably by balancing savings from the shorter delay in beginning the business operations against possibly irrecoverable compliance costs incurred in completing other procedures. Since the probability of securing the licensing varies from case to case and entrepreneurs bear these compliance costs, it might be better to leave the decision to them. On this ground, IL regimes may be considered preferable to SSL regimes.

### ***Saving Monitoring Costs for Officials?***

A third possibility is that SSL regimes generate scale economies of enforcement costs in the case of multiple SSL requirements (Ogus and Zhang, 2005). So, before completing the set-up process, entrepreneurs may be required to demonstrate to an agency that they have already secured all necessary activity licences including e.g. a fire safety permit, a sanitary permit and a location permit. However, the same scale economics can be achieved also by IL regimes, provided that a single enforcement agency is authorized to monitor the various IL requirements. In addition to requiring entrepreneurs to present their licences in its office, the enforcement agency can also carry out investigations on its own initiative. Moreover, IL regimes have the added advantage of reducing the time to complete both the set-up process and IL procedures; under an SSL regime the procedure for checking the multiple requirements constitutes *de facto* a further barrier to entry.

In summary, the above analysis suggests that the hypotheses favouring SSL on public interest grounds may not be always justified. We turn next to possible private interest explanations for SSL regimes being preferred to IL regimes.

## **IV PRIVATE INTEREST EXPLANATIONS**

Private interest theory suggests that regulation serves the interest of particular groups (Ogus, 2004). And there are many studies which purport to show that specific licensing regimes benefit particular interest groups (Svorny, 2000) According to this theory, existing suppliers are motivated to influence the promulgation of licensing requirements which can often limit competition and, in certain circumstances, raise their profits. They are usually able to do this successfully since they typically face lower information and organization costs than dispersed consumers. Politicians may, therefore, be prepared to meet the demand of suppliers' groups for the licensing legislation in return for campaign contributions, votes and even bribes. Bureaucrats may use licensing regulations to obtain larger budgets, prestige, manpower and further employment conditions. Most importantly, the discretion involved in licensing decision-making creates opportunities for exacting bribes. Moreover, because of their key role in policy-making, such as controlling information, bureaucrats can easily impose licensing regimes. In this section, we explore these hypotheses, to ascertain whether SL regimes can confer more benefits to the interest groups than IL regimes.

### **Set-up Licensing Agency**

Under an SL regime, entrepreneurs who fail to get an approval from the licensing agency should not, at least in theory, engage in subsequent procedures to enter the market. The

arrangement might, at least ostensibly, give a good excuse for the licensing agency to rely on verification by other agencies responsible for subsequent procedures and then relax its efforts to police unlicensed activities.

The delay involved in obtaining an SL licence can often impose more costs on entrepreneurs than an equivalent delay under an IL regime. With regard to the latter, so long as it takes the entrepreneur less time to complete the delayed IL procedure than the set-up process, then the delay by the licensing agency will not affect the total time for completing both procedures. But under an SL regime, any delay by the licensing agency will directly increase the total time for both procedures. The higher delay costs imposed on the entrepreneur creates more opportunities for the licensing officials to extract bribes, because the entrepreneur's benefits from corruption are increased (Rose-Ackerman, 1999).

In some developing countries, once a licensing requirement has been established, the choice between SL and IL regimes is generally determined by bureaucrats. Even if politicians retain decision-making power, the licensing agency might still be able to persuade them to adopt SL regimes by collaborating with agencies responsible for subsequent checking procedures (ARSCPs). We will now see how those ARSCPs can benefit from SL regimes.

### **Agencies Responsible for Subsequent Checking Procedure**

Under an SL regime, the ARSCPs verify that the SL requirement has been met before the set-up process can be finished. The ARSCPs might be able to obtain power, prestige, and even bribes, since rejection of an application or delay in processing it can cause losses to entrepreneurs. In particular, the entrepreneurs might have invested a significant amount in the SL procedure before applying to the ARSCPs. The investments are generally sunk costs which will be lost if the entrepreneurs do not engage in the subsequent procedures with the ARSCPs. But under an IL regime, no agency is responsible for such subsequent checking in the set-up process. This means less power for the agencies in the IL regime to exchange for bribes or other benefits, than in the SL regime where they might be designed as the ARSCPs. Perhaps some benefit to ARSCPs might be inferred from their great enthusiasm for SL requirements when the public interest justifications are not very strong. In China, there were (at least) 146 SSL requirements at the national level in 2000: 29 of these were imposed by the National People's Congress and its standing committee; 79 by the State Council; and 38 by the National Industry and Commerce Administration (NICA) acting as an ARSCP or jointly by the NICA and another ministry (Enterprise Registration Bureau, 2000). It

has been suggested that the introduction in 2003 of the Administrative Licensing Act [Articles 14,15,16], which abolished rights of central ministries and local governments to impose SL requirements, was, in part at least, to prevent them (including NICA) from establishing the regimes for their own private interest (Qiao, 2003).

### **Existing Suppliers**

Existing suppliers may prefer SL to IL regimes. The longer entry time and higher entry costs can, at least to some extent, protect them against competition from potential or new suppliers. The costs reduce the number of suppliers and thus consumer choice; they may also result in increases in prices and the profits (rents) earned by existing suppliers (Ogus and Zhang, 2005). These latter effects rely on the availability of substitute goods and services in the market: the less willing consumers are to change demand to such substitutes, the higher the price increases and the more profits to suppliers (Svorny, 2000).

If the costs of coordinating the existing suppliers are low, and there is an effective channel for them to influence policy-makers, the existing suppliers might be able to further their interests very easily. In developing countries, the market is often dominated by relatively few, but powerful, incumbents, including state-owned enterprises, which can easily obtain the government's support in establishing the SL regimes to their advantage. Even if the above conditions do not arise, existing suppliers may be able sometimes to harness their demand for regulation to that of groups which easily obtain public supports, for example, those representing consumers, who think that they will benefit more from SL regimes than from IL regimes (Ogus, 2004).

### **Politicians**

In developing countries, the distinction between politicians and bureaucrats tends to be blurred and an alliance between the ruling elite and high-ranking officials has often led to an "oligarchy of power and privilege" (Seidman and Seidman, 1994). These groups may have some common interests in choosing the SL regime. Moreover, perhaps for psychological or cultural reasons, more *ex ante* prevention might be preferred by the public who are more risk-averse and more likely to accept power inequality between government and individuals (Baptista, 2004). Accordingly, SL regimes might, more easily than IL regimes, enhance the reputation of politicians in developing countries where many people appear to have the above characteristics. This may increase the politicians' prospects of re-election, or facilitate their ruling power.



Finally, it may be that all these interest groups, agencies, existing suppliers and politicians, can secure greater benefits from GSL regimes compared to SSL regimes, because the coverage of the former is wider, imposing licensing requirements on all business sectors.

## **V CONCLUSION**

In this paper, we have investigated the use of licensing procedures in the business set-up process in developing countries. It seems that some developing countries still widely use set-up licensing (SL) regimes. The SL regimes impose more compliance costs on entrepreneurs, more administrative costs on officials and more welfare losses on consumers than independent licensing (IL) regimes. Our principal aim has been to explore the public interest justifications for these SL procedures.

As we have seen, few general set-up licensing (GSL) procedures can be justified since it is difficult to identify a licensing requirement appropriate for all sectors, all firms and all activities. Not all business activities involve substantial potential losses and at least some potential losses can be better addressed by *ex-post* systems of deterrence including information regulation (mandatory disclosure) and/or on-going performance standards. In contrast, the sectoral set-up licensing (SSL) regime might, in relation to the sector concerned, be preferable to other regulatory techniques, but it is often difficult to rationalise its role as one step in the set-up process. The argument favouring SSL regimes for their roles in improving compliance ignores a possibility that more applicants might thereby enter the informal economy without going through any official procedures. We have also suggested that, if an IL regime is adopted, effective regulatory compliance can be achieved provided that some necessary measures are taken by government. And we suspect that the related administrative costs of these measures will sometimes be less than the additional compliance costs and welfare losses of an SL regime. We also have reason to doubt the argument that SL regimes may reduce monitoring costs and compliance costs for other procedures.

It seems that private interest explanations are more convincing than public interest justifications. The SL agencies, the agencies responsible for subsequent checking procedure, existing suppliers and politicians can all obtain better benefits from SL regimes than from IL regimes. Especially in developing countries, the powerful alliance of politicians and bureaucrats can exploit SL regimes to their own advantage, and at the expense of new suppliers and consumers.

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## Notes

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<sup>†</sup> The work forms part of on-going research conducted under the auspices of the Centre for Regulation and Competition (CRC), University of Manchester and financed by DFID. A draft of the paper was presented at the CRC 3rd Annual Conference (2004), Cape Town, South Africa and we acknowledge the helpful comments of participants there.

\* Correspondence to: Qing Zhang, School of Law, University of Manchester. Oxford Road, Manchester, M13 9PL, UK. Email Address: zhang.qing@manchester.ac.uk .

\*\* Correspondence to: Anthony Ogus, Professor of Law, School of Law, University of Manchester; Oxford Road, Manchester, M13 9PL, UK. Email address: anthony.ogus@manchester.ac.uk ; Tel: +44 1612753572

<sup>1</sup> A telephone interview between Qing Zhang and an officer (who wishes to remain anonymous) in the State Industry and Commerce Administration, the People's Republic of China.

<sup>2</sup> If the registration procedure is not merely for the business subject to the SSL requirement (i.e. there exist some businesses not subject to SSL regimes), the losses from the compliance costs might not be so large, because the costs of the registration will be shared with the businesses not requiring licences.