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**TOWARDS APPROPRIATE  
INSTITUTIONAL  
ARRANGEMENTS FOR  
REGULATION IN LESS  
DEVELOPED COUNTRIES**

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# **TOWARDS APPROPRIATE INSTITUTIONAL ARRANGEMENTS FOR REGULATION IN LESS DEVELOPED COUNTRIES**

**Anthony Ogus**

As the globalisation of markets has grown apace, so Western ideas of regulation and deregulation have had a growing influence on governments in developing or “transitional” countries. Indeed, donor institutions, such as the World Bank and the International Monetary Fund, have applied pressure for Western models to be adopted. The assumption, sometimes explicit, sometimes implicit, is that these models serve to improve economic performance. Yet actual or attempted applications of Western models have often, it seems, been insensitive to the key question, to what extent the recipient country is able successfully to integrate the models, particularly with reference to their institutional implications. My primary concern in this paper is, therefore, to examine how conditions prevailing in less developed countries (LDCs) may impact on the institutional arrangements for regulation, and how these might be taken into account in designing regulatory regimes.

I begin by sketching the background to these issues: the importance of the legal system and regulatory arrangements for economic development; and how views have diverged over time in how LDCs should solve problems in this respect. By way of critical commentary on such views, I identify some characteristics of LDCs which may inhibit the effectiveness of the transplant of Western models of regulation. I then relate those characteristics to some key features in general strategies for regulatory design and reform. In the remaining part of the paper, I draw on particular studies which I have undertaken on licensing and corruption, to illustrate the general themes and to provide concrete examples of how they might influence regulatory design.

## **1. BACKGROUND**

### **(a) Law and Economic Growth**

Surveys of empirical studies undertaken on the relationship between legal and institutional variables and economic growth in developing countries reveal very mixed results (Messick, 1999; Davis and Trebilcock, 2001; Djankov et al 2002; Shleifer et al, 2003). Perhaps surprisingly, the evidence that higher levels of democracy lead to higher

growth rates appears not to be conclusive (Barro, 1997). Nevertheless, studies of the rule of law and the quality of legal institutions (e.g. Keefer and Knack, 1997) do report positive correlations, the evidence suggesting that effective protection of the property rights of investors and officials operating within a framework of known legal rules are conducive to stronger economic development (World Bank, 1997, Beck et al, 2001). A key variable is the perceived vulnerability or invulnerability of institutions to subversion by powerful citizens (Glaeser et al, 2003).

The quality of the judicial process is assumed to be related to economic performance, and attempts have been made to derive reliable quantitative data on key variables and their impact on costs (Sherwood et al, 1994). Attempts have also been made to relate particular aspects of legal systems to economic development. Commercial law should lend itself well to analysis of this kind, but there has been a paucity of empirical work in the area. It has been shown that growth occurs in countries where secured creditors are guaranteed repayment of their loans (Levine, 1999) and where corporate shareholders are adequately protected (La Porta et al, 1998). However, these and other studies (e.g. Fafchamps and Minton, 2001; Kamarul and Tomasic, 1999) show that, in the absence of effective formal mechanisms for resolving disputes, there will often be resort to informal systems which in the context may be equally, if not more, effective.

The importance of effective, informal processes of disputes resolution might also provide a convincing explanation for the economic success in the People's Republic of China, notwithstanding perceived weaknesses there of the court system and the formal enforcement of legal rights (Clarke, 2003). So also, with the so-called "East Asian miracle" which has occurred notwithstanding the failure of many legal reforms, based on Western models, to penetrate commercial life (Pistor and Wellons, 1999; Lindsey, 2004). Resort has been had, instead, to arrangements made between business elites and the governments and sometimes by discretionary executive rulings, disputes being dealt with usually by informal negotiation aided by mediators. "Formal law was used to the extent it complemented or supported this arrangement, but was ignored by economic and government agents alike and substituted with alternative rules, if it ran counter to it" (Pistor, 1999).

At the risk of over-simplification of all this evidence, we can accept the generalisation that legal infrastructure is connected to economic growth, but it is not necessarily the legal infrastructure that emerges from Western models. The "rule of law" is important, particular

where it implies the stability of rulemaking, respect for basic property and contract rights and an independent judiciary with some ability to command compliance from government and politicians. At the same time, informal systems of dispute settlement and enforcement may prove sufficiently effective.

(b) "Law and development" theory and its impact

In the light of these conclusions, it is interesting to observe how specialists in legal systems in LDCs have, over time, come up with remarkably divergent recommendations regarding reform. The first wave assumed that underdevelopment was the result primarily of a failure to adopt Western styles of liberal democracy, including independent courts ready to uphold well defined property rights and contractual entitlements. In consequence, inspired by Weberian analysis (e.g. Trubek, 1972), they envisaged that the import of Western models would be the key to success. A number of legal scholars, mainly from the USA, and under the aegis particularly of US AID and the Ford Foundation, became involved in devising legal reform programmes for developing countries and actively promoting American "legal style" (Merryman, 1977).

The movement proved to be a failure. After closer study of what actually happens when simple transplants of Western models were attempted, there was a quite radical change of opinion by those involved (Trubek and Galanter, 1974). It was now recognised that the matter was more complex and that the role of law and legal institutions in such societies could only be understood by reference to their cultural and political environment. Legal reforms without due regard to these factors were doomed to failure (Faundez, 2000). One obvious example – to which we will in due course return – is that in many developing countries informal means of resolving disputes are more important than formal methods. And that is just part of the more general question of reconciling Western-style legal institutions with customary law, a problem which survives from the colonialist period (Seidman and Seidman, 1994).

Another perspective on law and development reflected the collectivist ideology current in the 1960s and 1970s. On this view, the mistake was to import legal institutions designed primarily for liberal "capitalist" economies. What was needed was a strong state interventionist approach, capable of invigorating economic development by Keynesian measures, rendering development less dependent on external forces (Snyder, 1980) and

also (according to some) redistributing the resources more equitably (Ghai, 1993)). Understandably in vogue at a time when the Soviet Union and other socialist countries were able to offer political and financial support, this approach in its turn became outmoded, not the least as it did not, in most cases, seem to yield the promised degree of economic growth. Indeed it served more obviously to reinforce the position of the political elite and the bureaucratic classes (Ghai, 1986).

What may be described as the “third wave” of theories concerning law and development was a consequence of politico-economic changes, most obviously in Eastern Europe and the former Soviet Union, but also in the West with the policies of privatisation and deregulation. Initiated by the oil crisis and the problem of escalating public sector budgets, governments felt constrained to review and restructure state-market relationships. As the economic crisis extended to developing countries, so their dependence on donor organisations grew. Legal reform occupied a prominent place on their agenda for two reasons. First, because, consistent with policy analysis in the industrialised world, economic stagnation was identified with notions of “state failure” and the regeneration of the private sector was considered to require new legal definitions and processes for delimiting the role of the state (Tshuma, 1999). Secondly, influential voices were becoming increasingly convinced that “good governance” was a crucial variable in explaining differential rates of economic growth. Since donor organisations were reluctant, or not allowed, to address the political dimensions of good governance, the focus shifted to strong legal frameworks and effective principles of accountability (World Bank, 2002). Loans and other forms of aid were thus made conditional on progress with legal and judicial reform.

No doubt some lessons had been learned from previous failures (World Bank, 2002, 11-16). Less was attempted by way of transplanting particular models of legal organisation, and there was a compensating focus on the basic essentials necessary for the rule of law. This involved, notably: a relatively stable body of rules, known in advance and enforced by independent adjudicators; and basic systems of property and contract rights (World Bank, 1992 and 1997).

## 2. GENERAL STRATEGIES

In the light of this background, I will now focus on the institutional structures relevant to regulatory systems and explain how they may affect general strategies for regulatory reform.

(a) The rule of law: the traditional focus

I begin with "the rule of law" which, as we have seen, at the heart of the infrastructure recommended by most commentators. There are, however, different interpretations of the "rule of law" (Grote, 1999). Clearly, most reformers do not take this to mean simply "rule *by* law", that is a system, operating in a number of Asian countries, where law is used primarily as a mechanism for exerting governmental power, with dispute resolution as a subordinate function (Carothers, 1998, 96). As linked to the familiar concept of "law and order", a system so characterised may be one subservient to tyrannical and arbitrary government. On the other hand, although democratic processes are in practice often linked to rule of law variables, it seems preferable to exclude this area of governance from the definition, not the least as, in recent years, the World Bank and others have been seeking to induce rule of law reforms in countries where movement away from undemocratic systems of government is highly unlikely (Messick, 1999).

A key characteristic of the "rule of law" is, nevertheless, the notion that government is itself the subject of law (Frischtak, 1997). More specifically, we can identify the following as commonly stated requirements (World Bank 1992; Sherwood et al 1994; World Bank 1997; Faundez, 1997; Carothers 1998; Perry, 2001).

- rules published and thus readily accessible
- rules which are reasonably certain, clear and stable (thus excluding decisions of unconstrained discretion)
- mechanisms ensuring the application of rules without discrimination
- binding decisions by an independent judiciary
- limited delay in judicial proceedings
- effective judicial sanctions
- compliance by, and accountability of, the government and its officials in relation to relevant rules

A list of this kind may appear trite and superficial. The requirements are objective and thus may be applied relatively easily to a given jurisdiction by examining its formal content. But, for that same reason, they may also reveal too little as to the actual working of the system in practice and this has led to more ambitious types of definition (Stephenson, 2000). Of course, ideally one would wish to test the quality of outcomes in terms of, for example, justice or fairness, but this is subject to the obvious difficulties that such judgements are necessarily subjective and cannot be made without accepting some prior understanding of what constitutes "justice" and "fairness", as to which, particularly in a cross-cultural context, there may be little agreement. Another possibility is to fasten onto some key functions, such as the extent to which judicial decisions constrain executive discretion, and measure a system's performance accordingly (see e.g. Ramseyer and Rasmusen, 2003). But this too has its problems: can the assumption be made that it is the legal institution, rather than some other phenomenon, which induces the observed outcome? Is it possible to generalise sufficiently from the chosen function or functions?

These difficulties have not inhibited Western commentators, and donor institutions in particular, from advocating major reforms of LDC legal systems. These have focused on improvements to the institutional base of law, notably to courts, judges, government law enforcers and bureaucracies and attempts to render government institutions more compliant with, and accountable to, the law. In many developing countries these reforms have failed, to a greater or lesser extent, to achieve the desired objective. The veneer of legal institutions and applicable legal principles may have been substantially altered, but what went on beneath has often been stubbornly familiar (Ghai, 1986). Courts have continued to be weak, often as a result of political interference, a lack of transparency of decision-making and often corruption among the judiciary, police and bureaucracy (Mattei, 1997).

The literature furnishes us with two principle explanations for the failure of the reform movement. The first is bureaucratic failure. The Weberian model has not easily been transplanted to developing countries (Seidman and Seidman, 1994). Bureaucrats, especially in the higher ranks, have tended to be tightly knit with offices often being linked by political and ethnic ties with the ruling elite. This means that it has often been impossible to draw a clear line between what is political activity and what is bureaucratic activity. And it may too easily have been assumed that, in an autocratic state governed by a ruling elite, it would be relatively easy to secure obedience from junior officials. In fact, even within such political systems a great deal of political conflict and tension between different groups occurs within bureaucracies (Rondinelli, 1993, chap. 6).

The second is the lack of political will to see through the necessary reforms (Ghai, 1986). It may have suited the ruling elite to maintain the rhetoric and images of significant legal reforms but it remained in their own interests for the reforms to be “paper” reforms only.

(b) The rule of law: culture and resources

There are two major shortcomings to this traditional focus on the rule of law and the explanations for the failure of reform. Most importantly, they fail to take sufficient account of the cultural gap. Even if appropriate institutional structures are put in place, and with adequate resources, it is rash to assume that the individuals involved will behave in the same way as their Western counterparts (Seidman and Seidman, 1994). And the very notion of considering the legal implications of an activity or a transaction, let alone invoking the law in some practical way, might be alien to all but a small proportion of the population. More than this, in many LDCs and to a greater or lesser extent, the Western model of rule-making and adjudication is alien to the traditional culture which, in the words of Mattei, involves “a reduced role played by lawyers ...[compared to that of] mediators, wise men, religious authority; ... high legal value of penitence; the importance of the homogeneity of population as a means of preserving a particular social structure; family groups rather than individuals as the building blocks of society; a high level of discretion left to decision makers; a high rate of survival of very diversified local customs; extensive use of judicial coercion; a strongly hierarchical view of society” (Mattei, 1997, 39). And, as we have seen, the existence of this kind of culture is not necessarily incompatible with strong economic performance.

The other neglected dimension is that of resources. The key question, as recognised in an important but less well-known paper of Posner (1998), is how legal systems should be designed where the resources available for investment in them are more limited than in developed countries. As he observes, the quality of the legal institutions may be a consequence of, rather than a reason for, economic growth – richer countries may simply be able to invest more in the legal system.

As an example of how the resource issue might affect legal arrangements, Posner contrasts rule-formulation with legal institutional arrangements. The marginal costs of the former are negligible; the latter requires relatively heavy investment in terms of labour costs. In consequence, he argues for a policy of selecting rules which reduce the institutional costs. Such a policy may affect the content of specific rules, for example, that contracts have to be in writing to be legally enforceable; and that certain types of disputes must be submitted to

binding arbitration. It may also guide the general character of the rules which ought to be relatively straightforward to apply, and not requiring a significant exercise of discretion (see also Schaefer, 2002). Elsewhere I have made equivalent suggestions as to how administrative costs may be reduced in the selection of regulatory instruments and processes (Ogus, 2003) and in this paper I develop the theme further by reference to some particular features of regulatory systems.

Nor should "resources" in this context be construed narrowly. Not only is there the manpower needed to monitor conduct and to process and enforce rules and sanction systems, as well as investment in information technology to facilitate communication and therefore also the effectiveness of decision-making. There is also the question of human capital, lower educational attainment affecting both the quality of decision-making by officials (Schaefer, 2002) and the ability of ordinary citizens to initiate or contribute to the enforcement process.

#### (c) Creative responses to the cultural and resource constraints

One possible set of responses to the cultural and resource constraints outlined in the last section are essentially negative. The limitations are recognised but not such as to lead to a change of strategy; rather the reform ambitions remain in place with exhortations to do the best within the circumstances prevailing. I believe, in contrast, that a more creative response is possible, using the constraints to explain and justify divergence from, rather than partial adherence, to the Western models.

Take, first, systems of traditional or customary law which in some LDCs may be particularly strong. These, as we have seen, tend to be deeply rooted in social structures and are often marked by a high level of discretion in decision-makers, rather than rules (Mattei, 1997; Read, 2000). At the same time, in many societies, indigenous law has not been static, clinging inexorably to tradition, but rather flexible and, in particular, adaptable to the changing political and economic circumstances of the colonial presence (Chanock, 1985). The relationship between such law and modern, often western-inspired regulatory regimes may be problematic, giving rise to a complex combination of different normative systems, formal and informal, but for those regimes to be effective the relationship is important (Benda-Beckmann, 1992).

If the regulatory regimes can in some way be identified with, or internalized by, the community, either within or outside traditional law, this will much facilitate monitoring and

enforcement (Fafchamps and Moser, 2002), both of which are heavily resource-intensive. This suggests, in turn, that regulatory goals may be more effectively pursued if they coincide, or are compatible, with community norms (Cooter, 1994). And then there is the question of sanctions. The application or threat of conventional penal or administrative sanctions may, in some LDC contexts, appear often to lack effectiveness. This may be because of corruption – to which I will return. But it may also arise as consequence of problematic deterrence, since that those failing to comply with the law might not have sufficient assets to be able to pay fines, and there is an understandable reluctance to impose the principal alternative, imprisonment for relatively minor contraventions (Polinsky and Shavell, 1992). However, if the regime is, to some extent, integrated with traditional or community norms, then contravention is likely to lead also to stigma, which can be a highly effective and low-cost deterrent (Braithwaite, 1989).

There is another potential solution to the sanction problem which does not seem to have been sufficiently explored in the law and development literature (for its application more generally, see Kraakman, 1986). Legal and regulatory systems can focus their enforcement efforts not so much on those who actually contravene the rules and who have insufficient wealth to be able to pay penalties, but rather on third-parties who can control the contraveners' conduct and do have sufficient assets for financial penalties to be effective in relation to them. This is the economic justification for the familiar legal concept of vicarious liability (Sykes, 1984). So, for example, a firm or employer can be held responsible for the contravention, in the expectation that it can apply effective informal sanctions on those employees whose conduct engages that responsibility. And in some LDC contexts, that idea might be extended to render the extended family or community responsible to equivalent effect.

Finally, there is the question of rules versus discretion. An important development in recent years in Western models of regulation (and deregulation) has been the tendency to replace heavily rule-based regimes by more general principles, thus conferring more discretion on regulatory agencies and enforcers to take account of specific and localised circumstances (Ogus, 2000). In an LDC context this would seem to have the advantage that it accords with the culture of traditional or customary law which, as we have seen, typically applies a high level of discretion. However, in relation to regulatory regimes which are not integrated with that law, the consequences may be problematic. That is, first, because the exercise of discretion requires greater knowledge and expertise than the simple application of rules, and therefore is (relatively) more in societies with lower standards of educational attainment

(Schaefer, 2001). And secondly, because, as we shall see, discretion can, more easily than rules, be exploited for the purposes of corruption.

### **3. LICENSING**

In the next two sections, I draw on studies which I have undertaken on two specific aspects of regulatory regimes in LDCs, licensing (Ogus and Zhang, 2005) and corruption (Ogus, 2004a).

#### **(a) Licensing generally**

A licensing regime is a regulatory instrument which controls entry to the market. It tests the suitability of applicants and/or their circumstances as suitable suppliers of goods or services. Even where entry standards are detailed, some degree of judgement by the decision-maker (which may be a committee rather than an individual) is inevitable; and of course, the standards may be so general in character that a broad degree of discretion is exercised by officials. For some licences, the process may be prolonged by the need to investigate in detail the application, perhaps consulting with third parties and/or engaging in on-site inspections.

Licensing systems are very expensive to administer and that takes us to a major paradox. LDCs, with more limited resources, tend to use licensing much more than more developed countries (MDCs) (Djankov et al, 2002). For equivalent regulatory purposes such as the safety of products or services, or for consumer protection more generally, MDCs tend to prefer what can be called *ex post* regimes: all businesses and operations in the market must comply with on-going standards but do not have to demonstrate compliance prior to commencing business activities or operations. Monitoring and enforcement thus takes place during the currency of operations, and often on the basis of risk assessment and sampling; in consequence administrative costs tend to be lower.

#### **(b) Public interest justifications**

How can this paradox be explained or justified? Let us, first, examine some public interest arguments for using licensing as a regulatory instrument (Ogus, 2004b, chap 10). Consumers in dealing with many types of business purchase "experience" goods or services, those the quality of which cannot easily be ascertained prior to purchase (Nelson, 1970). While sellers of higher quality products and services may be motivated to provide relevant information, this may be not be reliable, because private legal instruments to verify and

enforce the validity of the information are costly to activate. However, there are usually cheaper ways of meeting the problem than subjecting all suppliers to prior quality approval. In particular, information which might have been voluntarily given can be the subject of mandatory disclosure obligations.

In what circumstances is such mandatory disclosure unlikely to prove adequate? We may note, in the first place, that governments may not always trust individuals, with appropriate information to make decisions which are in their own best interests. They may then attempt to justify the exclusion from the market of those failing to satisfy minimum standards on a paternalist basis (Ogus, 2005). Of course, the ability to acquire and process relevant information is related to educational levels. It may therefore be that this form of market failure will be more pronounced in developing countries and therefore the stronger will be the case for interventionist, or paternalist, policies; hence a greater use of licensing. However it is doubtful whether the very high additional costs of licensing regimes can be justified in LDCs on this basis alone.

A second set of arguments concerns enforcement. The critical difference between licensing and *ex post* regimes is that under a licensing regime all suppliers must have their application scrutinised to ensure that they satisfy, or in some cases are deemed capable of satisfying, the entry standards; on-going standards can be enforced only *ex post* entry and then in practice only in response to suspicions, complaints, or some policy of sample monitoring. For compliance with on-going standards, the sanctions imposed *ex post* must serve to deter the socially undesired behaviour; under a licensing regime, it is more a case of preventing such behaviour. To justify the very high additional costs of universal testing operating in LDCs, we must therefore identify circumstances in which a strategy of mere *ex-post* enforcement may generate correspondingly large welfare losses. The main argument, here, is that LDCs do not typically have the capacity to operate effective deterrence under *ex post* regimes. In most developing countries the resources made available for systematic and widespread monitoring are very limited. Low educational attainment and poor informational channels may also significantly reduce third party involvement in the enforcement process. In any event, there will be little incentive to complain, if the citizens concerned are benefiting from the trader's activity. Finally, and for a variety of reasons, there may be difficulties in securing condemnation from courts or other enforcement institutions.

These would seem to be powerful public interest justifications for the greater reliance on licensing in developing countries. But further consideration throws some doubt on them. They presuppose that the concentration of resources at the *ex ante* stage is more effective than if the same resources were deployed in *ex post* monitoring and enforcement. This is a proposition requiring empirical validation, but intuition suggests that the assumption may be unwarranted. While the system of *ex ante* scrutiny may be sufficient to exclude from the market some traders likely to generate significant losses, others may prefer to operate unlawfully without a licence (Johnson et al, 1998); and there is evidence of large numbers of unlicensed traders operating in the informal economy in some countries (Suhir and Kovach, 2003). To constrain the losses from such activity, resources must be made available for policing and monitoring, for citizens whose preferences are met by unlicensed suppliers have no motivation to report the illegal activity.

Further, when *ex ante* scrutiny does take place, some *ex post* monitoring is necessary to ensure that a firm does not subsequently default on its licence conditions. This may, to some extent, be alleviated if licences have to be periodically renewed but that, of course, adds significantly to the costs of the system. Also renewal can only be refused if there is evidence that the licence-holder no longer complies with conditions. Without monitoring or some third party complaints, such evidence may be difficult to obtain. In short, in the absence of empirical data, it is difficult to reach definitive conclusions on whether licensing regimes can be justified on public interest grounds, but the arguments are not, by themselves conclusive.

### (c) Revenue raising

There are two other sets of arguments which can be involved: these explain, rather than justify, the greater use of licensing in LDCs. The first is revenue raising. It is clear that many developing countries use entry controls primarily as taxation instruments, often for local government purposes (Devas and Kelly, 2001). The fees payable on registration, or to obtain a licence, can be set at a level above that necessary to cover the costs of administering the system.

It is not difficult to explain this practice. Revenue-raising by conventional taxation methods is difficult, costly and prone to corruption. Although, as we shall see, entry controls also create opportunities for corruption, the relatively simple process of receiving information, particularly in relation to registration systems, does not confer much power on officials over

traders, because little or no decision-making takes place. No doubt, too, traders are less resistant to paying taxes if they are disguised as fees.

There are, nevertheless, some disadvantages in using entry controls for fiscal purposes. First, the higher the fee levied for registration or a licence, the larger the number who will avoid complying with the requirement and rather participate in the informal economy. If the entry control is imposed only as a fiscal device, that is simply equivalent to tax evasion, but if it has other, public interest, purposes then those purposes will be jeopardised. Secondly, to achieve the advantages claimed over conventional tax methods, the registration or licence fee will generally have to be flat-rate and that might not be easily compatible with fiscal policy. The latter might, for example, require that the amounts levied should vary according to the number of employees or the turnover of the firm.

#### (d) Private interest explanations

The second set of arguments relates to the private interests of, particularly, politicians and public officials in maintaining entry controls. In the broadest sense, widespread regulation of market entry implies a large degree of government control over the economy as a whole. Control of market entry has deep historical roots (Ogus, 1992), being deployed particularly during periods when rulers wanted to enhance their power by maintaining hands on key industries. There is a reluctance on the part of some politicians, particularly in LDCs, to relinquish the power derived from such control and the continuing use of some forms of entry regulation may to some extent be attributed to this.

Public officials may not enjoy power to the same extent as politicians, but they too may have an interest in maintaining systems of entry control (Breton and Wintroppe, 1982). Such systems normally require significant manpower resources and thus can further the employment prospects of officials. Distinct from, but connected to, these motivations is the important issue of corruption. Entry controls can obviously and easily serve this purpose, particularly where the granting of a licence requires some discretion on the part of an official, and/or where an application in person is required.

#### (e) Conclusions

The arguments considered in this section may not justify the institutional differences between regulatory regimes in LDCs and MDCs respectively, but they do help to explain them. The normative implications of the public interest analysis may then lead to perception that many of the licensing systems could, with economic benefit, be dismantled and

replaced with *ex post* regimes. However, the private interest analysis provides important indications of why such reform might be difficult to achieve.

#### **4. CORRUPTION**

##### (a) The problem and traditional responses

Corruption is recognised as being a major problem of legal and regulatory systems in LDCs (Transparency International, 2004). Studies in particular countries (e.g. China (Manion, 1996); India (Wade, 1982); Indonesia (World Bank, 2003)) indicate how regulatory decision-making is an activity particularly prone to corruption. It is not difficult to see why. Regulation confers power on institutions, but also officials, to make decisions on the use of resources which can generate very significant gains or losses for individuals affected by the regulatory instrument (Goudie and Stasavage, 1998). Most obviously this applies to public procurements and grants which generate direct financial benefits, and (as we have seen) to licences, which enable profit-making activities to take place, often with the profits enhanced by limiting the entry of others. It applies also to standards and other controls imposed by regulatory authorities in two different respects: the requirements may be interpreted by officials so as to benefit, or conversely to prejudice, particular individuals; and those apprehended for non-compliance may, or may not, be subjected to enforcement procedures and sanctions. Some forms of regulatory decisions, for example, negotiating the terms of a grant or scrutinising behaviour for compliance, necessarily involve personal contact between official and regulatee, thus enhancing the opportunities for corrupt transactions. In other cases, the opportunities may be deliberately created by requiring communications, such as applications for licences, to be made in person.

The importance of corruption for economic development, the large externalities associated with it and the vicious circle to which it typically gives rise, all suggest that a "macro" assault to destabilise it by a variety of policies and instruments is desirable. And, indeed, there are jurisdictions where this approach has been taken, apparently with considerable success: Singapore and Hong Kong are regarded as two prominent examples (Quah, 2001). But what these examples, and others, also reveal is that there must be the political will to adopt such an all-embracing approach, often through a combination of domestic interests and pressure from foreign institutions (Lindsey, 2002). In its absence, a virtuous circle will not emerge (see, for example, the experience in Cambodia, Laos and Vietnam: (Wescott, 2003). It then becomes a matter more for aiming at the optimal level of corruption (Klitgaard, 1988) recognising that the phenomenon is inevitable to some degree but encouraging strategies

which reduce the net costs. Such strategies require sensitivity to differences in the political and cultural environment of individual developing countries, but more importantly between those countries and industrialised countries, from where the traditional anti-corruption policies mainly originate.

Take, for example, policies directed towards reforming bureaucracies by reference to traditional, Weberian administrative and process values. These might include: depoliticising the civil service; removing conflicts of interests; raising the quality of public officials recruited; increasing transparency by insisting on clear procedural steps and articulated reasons for decisions; improving internal auditing and monitoring systems; and extending external powers of appeal and review (Rose-Ackerman, 1999, chap. 5; World Bank, 2003). Insofar as these developments require a strong and impartial judiciary, a proactive citizenry, adequate resources for auditing and monitoring behaviour, and effective procedures for implementing as well as formulating the principles of administrative law, they will in many countries have to overcome deeply embedded cultural attitudes and the cost will be simply too large. Experience in some Latin American jurisdictions provides a good illustration of this (Buscaglia, 1997).

We can nevertheless envisage more modest measures which, at the margins, may significantly improve procedures and thus prove to be cost effective. In South Korea, for example, resources have been invested in information technology which provides more information to citizens, automatically records transactions, thus rendering decision-making more transparent, and in some cases enables transactions to be made electronically, thus depersonalising the process (Seoul Metropolitan Government, 2001). The computerisation of the customs services in the Philippines is reported to have reduced the average period of processing a cargo from eight days to about two hours, with an assumed significant reduction in corruption (Ables, 2001).

Similar considerations apply to the use of the criminal justice system, a point which seems insufficiently to have been grasped in some of the deterrence literature which treats corruption like any other illegal activity (Bowles, 2000). This literature adopts variants of the standard Becker economic model of crime, requiring the cost to the offender arising from conviction, when discounted by the probability of apprehension and conviction, to exceed the utility to be derived from the criminal act (Becker, 1968). When applied to the corruption situation, this suggests that the size of the penalty should, after discounting for the probability of escaping detection, be related to the amount of the bribe (Rose-Ackerman,

1998). By itself that might not be problematic. However, account must also be taken of the level of detection and conviction. In many countries this will be very low as a consequence of insufficient resources being available for monitoring and/or the fact that corruption may have seriously infiltrated the law enforcement and criminal justice processes themselves. If under such conditions, the deterrent effect is to be preserved, the formal sanctions consequent on conviction must be of such a draconian severity that few courts will be willing to impose them (Cooter and Garoupa, 2000; Polinsky and Shavell, 2001).

To combat the lax enforcement problem, some (e.g. Doig, 1995; World Bank, 2003) argue that there should be a special anti-corruption agency, independent of the police, and it has been suggested (Quah, 2001) that the existence of such an agency in Singapore contributed significantly to the reduction of corruption in that jurisdiction. But, as we have seen, there was the political will there to adopt the "macro" approach. In the absence of such political will, as the experience of other countries suggests, the creation of a special agency can actually exacerbate the problem by creating more opportunities for corruption (Kaufmann, 1997).

#### (b) Designing regulatory institutions to minimise corruption

What emerges from the above analysis is that conventional strategies to constrain corruption are likely to be less effective in jurisdictions where corruption significantly infiltrates the criminal justice and law enforcement systems, where the resources available for monitoring the conduct of officials are relatively modest, or where the political will to adopt a "macro" approach to the corruption problem does not exist. An alternative strategy explores how institutional arrangements may be designed so as to limit the opportunities for corruption, or to render such opportunities less profitable. Now, of course, the problems that were identified in the last section do not become irrelevant; in particular there must be the political willingness to accept some reorganisation of regulatory arrangements. But that is very different from what is required to effect major cultural changes and actively to pursue and punish culprits.

Some of the possible reforms to regulatory structures correlate well with developments and tendencies occurring in industrialised countries (Vogel, 1996); others point in the opposite direction. Some remain ambiguous. For a good example of the latter, take the much debated, though largely unresolved, question is whether a policy of decentralisation, associated with Western regulatory thinking, facilitates or hinders corruption. On the one hand, it is argued that decentralised decision-making must by its nature be more

transparent than when carried out at a distance from the subjects affected – local information flows being more rapid – and therefore corruption is, in such circumstances, more difficult to conceal (Lederman, Loyaza and Soares, 2001). On the other hand, if law enforcement is largely in the hands of a centralised authority, the very distance of the formal audit systems from the subject of investigation may limit its effectiveness: in remoter areas the authority of the law may simply not be recognised (Green, 1997, 67). Moreover, the “once-for-all” payment necessary to secure the cooperation of the central official may distort the economy less than the variety of payments at other levels: the bribee can control deviations from agreed patterns of corruption and render its effects less uncertain (Shleifer and Vishny, 1993). Bardhan (1997, 1325) uses this argument to explain why Indonesia (where corruption has been centralised) has, in terms of economic development, been more successful than India (where bribery has been more fragmented) even though the perceived level of corruption in the two countries is not dissimilar (in the latest Transparency International (2004) rankings India is 90th<sup>t</sup> and Indonesia 133rd).

Related to the question of decentralisation is that of competition between regulatory offices and officials. Promoting some such form of competition would seem to offer a plausible, and not too costly, means of combating corruption or at least reducing the levels of bribes to be paid (Rose-Ackerman, 1978). There is some empirical evidence to support this: the overlap in the power of local, state and federal authorities to control illegal drugs has been thought to reduce police corruption in the U.S.A. (Bardhan, 1997, 1337); and a statistical study of corruption among the judiciary in Latin America suggests that this is less prevalent where there are viable alternative procedures for settling disputes (Buscaglia, 1997). However care must be taken as to how competition is introduced: a series of alternative individuals or offices providing the same service, or perhaps overlapping services, would meet the objective (Bowles, 2000) but adding further layers of bureaucratic decision-making would simply exacerbate the problem (Lederman, Loyaza and Soares, 2001). Also a lack of clarity in the demarcation of public services can increase bureaucratic discretion, leading to more corruption (Wescott, 2003, 261). Suggestions linked to the competition argument include using committees instead of single decision-makers; and regularly moving bureaucrats between various offices (Klitgaard, 1988, chap.3).

Deregulation is, of course, a major theme in Western regulatory developments and the first and most obvious, though not necessarily most significant, point is that, since many opportunities for corrupt transactions arise from regulation, a reduction in the amount or intensity of regulation should reduce the level of corruption (Lederman, Loyaza and Soares,

2001, 6). The legalisation of off-course betting in Hong Kong is a well-known instance of a simple deregulatory measure leading to a significant fall in police corruption (Klitgaard, 1988, 116). But that very example should alert us to the risk of reaching superficial conclusions on deregulation. The control of gambling is a relatively peripheral form of social regulation and, as such, should not be the basis of too broad generalisations about the undesirability of large areas of health and safety, and environmental, protection in developing countries. Given also that in many jurisdictions private law is ineffective to deal with many types of market failure, there is a strong *prima facie* case for regulatory intervention. It is, then, a question of exploring how an excess of regulatory opportunities for corruption may be dismantled (Platteau 1996).

A prime example is, as we have seen, licensing systems. A second possibility arises from the use of the criminal law to enforce regulatory regimes (Australian Law Reform Commission, 2002). In industrialised countries, the heavy cost of securing a conviction in the criminal courts may reduce its effectiveness as a deterrent; and for this reason administrative sanctions may be preferable (Ogus and Abbot, 2002). In developing countries, use of the criminal process has the added disadvantage that it creates a further opportunity for corruption. Evidence suggests that the level of bribes increases significantly when courts are involved in law enforcement (Green, 1997, 66-67).

In other respects, the need to constrain corruption suggests regulatory strategies which are incompatible with reforms taking place in industrialised countries. Regulatory discretion creates more opportunities for corruption than where regulatory requirements are the subject of clear and precise rules (Seidman and Seidman 1994: 178) and we have already suggested that, contrary to prevailing Western thinking, in many LDCs rules may be preferable to discretion. A similar argument applies to the choice between formal and informal rules. In industrialised countries, there has been a perception that the traditional command-and-control sets of formal rules are often too prescriptive and too rigid, firms often knowing better than regulators what can best meet the regulatory goal at lowest cost. There has therefore been a movement to replace formal rules by guidelines (Baldwin 1995). The experience with informal rules in LDCs (e.g. Zimbabwe: Goredema 2000) has not been a happy one. Individuals have often been faced with a multitude of highly specific regulatory rules and procedures, knowing that in practice these may not be adhered to, and that informal rules, built into informal relationships with those who are to be favoured, will prevail. Those unwilling to submit to the conditions of the informal rules, and their financial

implications, can still be subjected to the, often unreasonable, exigencies of the formal rules. The policy implication seems to be fewer and simpler formal rules, but not informal rules.

Finally, and perhaps more controversially, there is the question of consultation processes. Within the Western tradition there has been an increasing emphasis on regulatees and third parties contributing to, and participating in, regulatory policy- and rule-making. The potential benefits, in terms of improved information flows, better transparency and greater accountability are substantial, but direct access to regulatory officials does of course increase the opportunity for corrupt transactions. In the USA, efforts to maximise consultation and, at the same time, to limit the opportunities of private manipulation of the policy-making processes have led to principles that private meetings and private communications between officials and third parties are to be placed on the official record (Breyer and Stewart, 1985, 663-671). However, adequately defining and policing the requirement of a "private" meeting, and maintaining in an accessible and transparent form the official record, may not in practice be achievable in many jurisdictions. If that is the case, then some compromising on the ideals of consultation may be the price to be paid for reducing corruption.

## **5 CONCLUSIONS**

In this paper, I have explored some major issues relating to the design of regulatory institutions in LDCs. My principal conclusion is that too much effort has been spent on attempting to transplant Western models and that insufficient attention has been given to the conditions under which such transplants may be more or less successful. I have identified culture and resources as two key conditions which inhibit acceptance of Western models. Even though these conditions are widely acknowledged as difficulties, the typical response has been to press ahead with the reforms and "do the best that can be done in the circumstances".

In my judgement, recognition of the conditions which inhibit the ready acceptance of transplants should lead to more creative policy-making in relation to regulatory arrangements. So, for example, as a general strategy, I suggest the exploration in relevant LDCs of the extent to which regulatory regimes can be integrated, or at least rendered more compatible with traditional, customary law and its institutions. Analogously regulatory goals and principles will be more effective if they can be internalised as social norms, not the least

because community disapproval can be better at inducing compliance than conventional penal or administrative sanctions. Other general ideas include extending vicarious liability beyond its usual (Western) parameters and aiming at rule-based, rather than a discretionary approach, to regulatory administration.

That last suggestion contradicts much of the received Western “wisdom” on contemporary regulatory systems and, in my discussion of corruption, I take this theme further by focusing on the undesirability in many LDCs of facilitating “in person” contacts between officials and regulatees, and also enlarging consultation processes, since these can generate greater opportunities for corrupt transactions.

My conclusions on licensing are different. I am skeptical of the argument that conditions in LDCs justify the much greater use of this regulatory instrument, compared with industrialised countries, but reference to those conditions, particularly the opportunities which they systems create for private exploitation and corruption, helps to explain why licensing proliferates in LDCs and why reform in this area might be difficult to achieve.

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