Licensing Regimes East and West

Anthony Ogus\textsuperscript{a,b,c,*}, Qing Zhang\textsuperscript{a}

\textsuperscript{a} School of Law, University of Manchester, Oxford Road, Manchester M13 9PL, UK
\textsuperscript{b} Centre for Regulation and Competition, University of Manchester, Manchester, UK
\textsuperscript{c} University of Maastricht, Maastricht, The Netherlands

1. Introduction

As recognised by OECD,\textsuperscript{1} the World Bank\textsuperscript{2} and others,\textsuperscript{3} the design of national regulatory institutions has an undeniable impact on economic performance. A critical area of regulation, but one still insufficiently explored in the academic literature,\textsuperscript{4} is that concerned with business entry and establishment. Before lawfully engaging in business, economic actors must, in almost all jurisdictions, satisfy certain administrative requirements, notably to obtain licences or authorisations. The economic impact of these requirements should not be underestimated, business people in particular regarding them as a major obstacle to investment and new ventures.\textsuperscript{5}

\textsuperscript{*} Corresponding author. Tel.: +44 161 275 3572.
E-mail address: anthony.ogus@man.ac.uk (A. Ogus).

\textsuperscript{1} Regulatory Reform, Privatisation and Competition Policy (1992).


\textsuperscript{4} The economic literature has tended to focus on occupational licensing which has special features. See S. Svonny, “Licensing, Market Entry Regulation”, in: B. Bouckaert and G. De Geest (Eds.), Encyclopedia of Law and Economics, Vol. III (Edward Elgar, 2000), 5120.

As surveys conducted for the World Bank\(^6\) and the European Commission\(^7\) have revealed, there are huge differences between jurisdictions as to what is required and the burden placed on actors. If the licensing systems broadly serve the same public interest purposes, why should this be? It is also the case that, in general, richer countries regulate entry less than poorer countries. This, too, appears to be puzzling, given that licensing systems are expensive to administer and poorer countries have fewer administrative resources available for the purpose.

In this paper, we examine the pattern of licensing systems in developing countries, as compared with that in industrialised countries (Section 3). Our focus is on social regulation, that is interventionist measures designed to deal with externalities and information asymmetry, though at points we consider also examples of economic regulation, which is concerned with inadequate competition as a form of market failure.\(^8\) In an attempt to explain the differences, we explore, in Section 4, the familiar public interest justifications for imposing significant conditions on business entry and how they may need to be adapted to the context of developing countries. Although not normally considered a public interest justification, revenue-raising is undoubtedly a major explanation of some entry controls in developing countries (Section 5). Many of the law-and-economics studies of licensing systems in industrialised countries conclude that their existence can plausibly be attributed to private interest explanations.\(^9\) We therefore, in Section 6, review private interest theories of regulation and the hypothesis that politicians, bureaucrats, and incumbent firms derive benefits from the administrative requirements with, again, a focus on how the theories may be applied in developing countries. We reach some brief conclusions in Section 7. We begin Section 2 by identifying different types of control, drawing a distinction between, in particular, registration which is a formal and largely automatic procedure and licensing which requires some judgement from officials.

2. Types of entry control

It makes analytical sense to draw a distinction between two main types of regulatory entry control.\(^10\) The first which we call registration (but which is sometimes referred to as notification) requires the actor to furnish the public authority with specific information prior to being allowed lawfully to engage in the business activity. Although an official may verify that all the required information has been provided, the process of supplying the information is formal, and the subsequent granting of permission

---


\(^7\) European Commission, Benchmarking: the Administration of Business Start-Ups (Final Report) (2002).

\(^8\) For this distinction between economic and social regulation, see A. Ogus, Regulation: Legal Form and Economic Theory (Clarendon Press, 1994), 4–5.

\(^9\) Svorny, above, no. 4, 309–314.

effectively automatic: there are no substantive conditions to be fulfilled and no evaluation of the actor’s capacity to engage in the activity. It follows that no bureaucratic discretion is involved.

The granting of a licence (or permit or authorisation) is different in that the process is intended to test the suitability of applicants and/or their circumstances against substantive conditions which may be more or less rigorous, and more or less explicit in the legislation governing the process. 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.

It may not always be easy to draw the line between the two types of regulatory instruments: for example, in practice the granting of a licence may be simply a “rubber stamp” exercise, involving only a most cursory scrutiny of the application. It may therefore be preferable to treat the systems together but on a spectrum, at one end of which individuals or firms simply list their names in an official register; and at the other extreme, the authorities engage in an intense investigation of the applicant. However, we adhere to the distinction, because – as will be seen – we consider that it has important theoretical as well as practical implications.

A second distinction, but again one not always easy to draw in practice, is that between entry licensing and operation licensing. Under a regime of the first type, a business cannot lawfully operate in any respect unless it has acquired the appropriate authorisation. Licensing in the second category requires authorisations for particular operations or transactions, but that does not affect the right of the business to exist or engage in other, unregulated, activities.

Licensing regimes must be contrasted with other regulatory instruments which are available to the policy-maker. The most frequently adopted alternative is to impose standards but not to require ex ante approval. All businesses and operations, whether or not licensed, must comply with on-going standards, but in the case of what we may call ex post regimes do not have to demonstrate compliance prior to commencing business activities or operations. Breaches of on-going standards often lead to financial or administrative sanctions, but in the case of licensed activities, flagrant or very serious breaches may sometimes result in the suspension or revocation of the licence. And the same sanction can effectively be applied to unlicensed activities, if the authorities responsible for enforcing on-going standards are granted the power to prohibit the offender from any further exercise of the activity. This is sometimes known as negative licensing, to distinguish it from cases where ex ante approval is required.

---

11 C. Scott and J. Black, Cranston's Consumers and the Law (3rd edn., Butterworths, 2000), 460. The World Bank study (above, no. 6) conflates the two types, but the EU study (above, no. 7) focuses mainly on registration.


13 Scott and Black, above, no. 11, 448.
Finally, under a system of certification, the suitability of actors and their circumstances for engaging in the activity are evaluated, but this is not legally required as a condition for the activity. The system thus functions primarily as a signal of quality to consumers who can choose nevertheless to deal with uncertified suppliers. However, it should be observed that, in practice, some certification systems become de facto licensing systems because there is insufficient demand from consumers for products or services from uncertified suppliers.

3. Patterns of entry controls in industrialised and developing countries

In this section we investigate entry controls in developing countries, comparing them with the use of these regulatory instruments in industrialised countries. We classify the entry control systems examined into three categories. The first covers registration requirements for which little or no judgement is presumed to be involved. The second consists of licensing systems that in most jurisdictions are imposed on business entrants generally. Into the third category we place licences which apply only to particular types of business. Our survey potentially covers an enormous range of regulatory regimes and although it is predominantly derived from reliable data collected for the World Bank, inevitably there is a risk of some over-generalisation. The third category is particularly problematic since there is such a diversity in practice. We adopt a highly selective approach, focusing on the People’s Republic of China and licensing systems there. Although we do not claim that these systems are necessarily typical, they are of particular interest, because of the attempts there to move from a traditional planned economy to a more market-based approach.

3.1. Registration requirements

In general, registration requirements in developing countries are more numerous and more cumbersome than those in industrialised countries. The latter typically cover registration with the corporate registrar, the tax authorities and the labour or other agency responsible for employees’ social insurance or welfare, but often little more. In developing countries the obligation typically extends to notifying other authorities, including statistical bureaux, the municipality, the courts and, sometimes, police, fire services, environmental and other such agencies. In Colombia, entrepreneurs must successfully complete 19 procedures before they are lawfully allowed to commence business and, of these, 12 would appear to be registration requirements.

14 Ogus, above, no. 8, 215.
15 Ibid., 221.
16 See the reference in no. 6, above.
17 Bureau of Industrial Economics, above, no. 10, 20–24; European Commission, Benchmarking, above, no. 7. Details on systems in inter alia Austria, Belgium, Finland, Greece, Luxembourg, Quebec, and Sweden collated for the Benchmarking report by WIFO can be found at: http://bm-licensing.wsr.ac.at/reports/reports.html.
18 Djankov et al., above, no. 6. See also the World Bank database, above, no. 6.
19 Detailed information on entry procedures in Colombia is available on the World Bank database, ibid.
3.2. General licensing regimes

There is a significant overlap in the licensing requirements typically imposed on businesses in industrialised and developing countries. Most industrialised countries adopt licensing regimes for land use planning (or zoning), environmental waste management and building safety.20 Some jurisdictions, but perhaps only a minority, require licences for employee health and safety.21 Some developing countries also use licensing regimes for land planning, environmental waste, building plans and employee health and safety.22 However, generally the licensing regimes are applied as part of the start-up requirements of business, rather than – as in most industrialised countries – only in relation to the land development, discharge of waste or building works, respectively. In other words, while industrialised countries predominantly use operation licensing systems for these purposes, developing countries tend to use entry licences.

In addition, there are several areas where operation licences are regularly used in developing countries but which are only infrequently subject to such regimes in industrialised countries. Among these, we should mention, first, the buying or leasing of land. This is quite independent of environmental planning objectives, resulting rather from ideological traditions regarding land ownership, particularly in Africa, with its importance for local communities, and in Eastern and Central Europe experiencing a transition from soviet systems of land use.23

An even more important function of operation licensing in developing countries is as a control on international trade in relation both to imports and to exports.24 Licensing systems which restrict the import of particular, listed products are used for both economic purposes (affecting, e.g., quantity, pricing and competition) and non-economic purposes (protecting public interests such as health, safety, and the environment). Although export licences are used by industrialised countries, notably to control movements in arms and some high technology products and to protect heritage goods, they are used more frequently and widely in developing countries, for example to prevent critical shortages of food or other essential products and for the protection of domestic industry and exhaustible natural resources.25

---

20 Bureau of Industry Economics, above, no. 10, 21–24.
21 For example: Austria, Luxembourg, Portugal and Sweden: see the WIFO reports, above, no. 17.
22 World Bank Database, above, no. 6.
24 There is a well-recognised difference between “automatic” and “non-automatic” licensing in this area. We are concerned only with the latter; the former can be categorised as registration and is used mainly for compiling trade statistics: see OECD, “Analysis of Non-tariff Measures: The Case of Non-automatic Import Licensing”, (2002), available at http://www.olis.oecd.org/.
3.3. Special regimes

There is an enormous variety of licensing regimes applicable to specific sectors of industry and professional and non-professional trades and activities. Two categories, while not unimportant, can be dealt with briefly. The first involves the selection of a firm to have exclusive rights of supply in a given industry or sector of the economy. As an instance of economic regulation, this is used to constrain competition, particularly where there are conditions of natural monopoly. As such, it has become an increasingly important regulatory instrument as, within a large number of countries, utility services have been privatised and licensing systems are used to designate the firms which are responsible for supply and the terms under which they may operate. Although the content of the licence, and the procedures used to select the appropriate firm, may be matters of concern, it is the policy of restraining competition, rather than the particular regulatory instrument used, which is of economic significance. The second area which we leave aside is that involving regulation of the liberal professions. This is a classic application of licensing and is clearly very important for economic reasons, but the law-and-economics analysis is familiar and well documented in the extensive literature on the subject.

Focusing, then, on social regulation and the use of licensing regimes to deal with risks of harm, we find that one approach widely adopted is to require those creating risks of a particular type to demonstrate that they have in place a system which will involve adequate precautions against the given risks, prior to obtaining authorisation under the general licensing system. Thus, in many jurisdictions we find such a regime exists to provide protection against the use of hazardous substances or where food substances are prepared or sold.

More frequently the ex ante control is classified by reference to the type of trade or activity, rather than by the nature of the risk, and it is made the subject of an autonomous regime. There are striking differences between the trades and activities selected for the licensing processes in industrialised countries. A perhaps typical list is that operating in the State of Illinois the legislation of which requires that special licences be acquired to operate any of the following: bowling alleys, circuses and carnivals; amusement arcades; gaming tables and implements; shooting galleries and gun clubs; skating rinks; auctions; florists; liquor outlets; horse drawn vehicles; taxicabs; theatres; sale of tobacco; vendor stands in particular locations; itinerant selling, peddling or soliciting; dwarf-tossing; tour service vehicles; and children’s hospitals. From other jurisdictions in the USA and the UK, we can add

26 Scott and Black, above, no. 11, 462–464.
30 Bureau of Industrial Economics, above, no. 10, 12.
31 Illinois Code; Chapter 110.
(from a huge list): ice cream buyers; hairdressers; funeral directors; pet shops; sellers of second-hand cars; tattoo artists; astrologers and fortune-tellers; nuclear installations; consumer credit; tree fellers; sex shops; massage establishments; saunas; motels; milk vendors; zoos; residential care homes; and pawnbrokers.32

There is a large overlap of special licensing regimes in industrialised and developing countries, though, as regards the latter, the phenomenon is related to their level of economic, culture and legal development. For the purposes of this paper, we are particularly interested in entry controls imposed where industrialised countries usually rely on the self-regulatory mechanism of the market or other regulatory instruments. We take our examples from the People’s Republic of China. China is currently attempting significant regulatory licensing reform as part of the transition from the planned economy to a greater reliance on market mechanisms.33

In China, even after some reform measures, there are currently over 146 industrial sectors in which firms are required to obtain special approval in addition to a general business registration.34 These controlled sectors include: agriculture, fisheries, minerals, energy and building industries, urban development, transport, firearms, ammunition and other explosives, chemical and pharmaceutical industries, professional services, non-professional services, financial services, telecommunications, media, education, waste management and foreign-related trades or businesses.

Focusing now on regimes which do not often have an equivalent in industrialised countries, we start with the agriculture and fisheries industries. Licensed activities here include: seed planting and trading, pig slaughtering and breeding, trading of embryos of livestock and poultry, the manufacture or trading of pesticides or veterinary medicines, the manufacture of feed and feed additive, the trading and importing of chemical fertiliser, the establishment of seafood wholesale markets, fishing in bays or fish farming, felling or transporting of trees.35 In the mineral and energy industries, we find licensing requirements for, notably: the exploiting and processing of mineral resources; the distribution (wholesaler and retail) and the storing of petrol, diesel, burning kerosene, aviation kerosene and fuel; the generation and trading of electrical power; and the exploitation of salt resources.36

Our next list is of licensed non-professional activities: overseas education agencies; marriage promotion agencies; job-hunting and recruitment agencies; travel agencies; security service agencies; hotel and restaurant management services; hotels, night clubs, amusement bars and facilities; funeral services; the casting and making of seals and stamps, geographical and building surveying.37 Finally, we should mention the licensing of some specific

32 Ogus, above, no. 8, 226.
34 The Enterprise Registration Bureau of National Industry and Commerce Administration of P.R.C. (hereafter ERB), Collection of Laws and Regulations Concerning Prior Approvals for Enterprises’ Registry (2000), 712. The list is incomplete. For example, it does not cover the education industry.
35 ERB, above, no. 34, 37–75; the licensing regimes of felling trees and transporting trees out of the forest regions are respectively stated in Article 32 and Article 37 of the Forestry Law of the People’s Republic of China (1998).
36 ERB, above, no. 34, 76–124.
37 ERB, above, no. 34, 15–19.
products that do not have equivalent controls in most industrialised countries. These include the manufacture and trading of food products; the manufacture, trading and use of radiation products; the manufacture of fire vehicles and fire extinguishers; the design, construction, and installation of pressure boilers and containers; the manufacture, processing, and trading of gold, silver and their finished products, the manufacture and repair of meteorological instruments; the purchase, processing, manufacturing and export of cashmere wool; and the manufacture and distribution of cars.  

4. Public interest justifications for entry controls

4.1. Reduction of administrative costs and registration

At its simplest, the provision of information by means of registration reduces the administrative costs of regulation. If, as is invariably the case, firms will be subject to taxation and become recipients of information from public authorities regarding their rights and obligations, it reduces the administrative burden if, at trivial cost, the firm gives prior notification of names and addresses. It will also facilitate law enforcement, should that become necessary.

Of course much more substantial information may be required under registration systems, particularly where the activity may constitute a significant risk to health, safety or the environment. While in some cases the authority may provide a simple form with boxes to be ticked, in others it may demand a detailed description of the activity and its potential impact. As the costs mount, to the regulatee of providing the information, and to the regulator in processing and storing the information, so we must look for larger benefits. It can be plausibly argued that, if the information in question would in any event need to be acquired by the public authorities for the purpose of devising regulatory policy or targeting enforcement strategy, then it is cheaper to acquire it by this method, rather than by, for example, the distribution and collection of forms. Securing the right to pursue the activity is a strong inducement for providing the information.

An additional argument, pertinent to developing countries, is derived from limited administrative resources. With this resource constraint, it may make sense to transfer the costs of securing such information to the firms themselves. It may also be assumed that, with limited information technology, on-line registration used frequently in industrialised countries may not be feasible. For the same reason, communications between different administrative agencies may be difficult and costly. It is, however, implausible that separate procedures or transactions can always be justified on this basis; and in some developing countries the “one-stop shops” procedures have been introduced. Therefore, the suspicion is that some of the arrangements can better be explained by private interest arguments.

38 ERB, above, no. 34, 11–15.
40 Morisset and Neso, above, no. 12.
41 In, e.g., Malaysia, Kenya and the Philippines. For general discussion, see F. Sader, “Do “One-stop Shops” work?”, FIAS (Foreign Investment Advisory Services) working paper, available at http://www.fias.net/documents/.
4.2. Licensing as an instrument of economic regulation

Entry and operation licensing of course generate much higher costs than registration. The scrutiny and evaluation of all applications create a heavy administrative burden: the time taken to reach the decision imposes a cost on applicants, but also on their customers who do not have the product or service available until the licence is awarded. In addition, there may be welfare losses if the system serves unjustifiably to restrict competition. The public interest arguments therefore need to identify significant benefits to justify these costs.\(^{42}\)

Let us first consider situations where licensing is used as an instrument of economic regulation, that is, deliberately to limit or exclude competition. We have seen that worldwide the device has served to regulate privatised utilities. In developing countries, it has also been employed to control imports and exports and thus inhibit international trade.

Economic theory tells us that, in general, it is appropriate to assume that competition is beneficial and therefore restricting entry by licensing is detrimental to economic welfare. There are, however, special circumstances where this assumption may not be justified. Within traditional welfare economics, the classic example is that of a natural monopoly.\(^{43}\) This occurs when very heavy initial set-up costs are incurred, with the consequence that significant economies of scale are generated over a large proportion of the output. It therefore makes economic sense to have a licensing system which procures only a single supplier.

There are some traditional development economic arguments for protecting domestic industries against foreign competitors. For example, it is sometimes said that “infant” industries with potentially comparative advantages need time to build up experience and expertise sufficient to meet such competition.\(^{44}\) A second, but related, argument relies on the inadequacy of capital markets in some developing countries to supply sufficient investment capital to firms or industries, thus also placing them under a competitive disadvantage compared with foreign enterprise.\(^{45}\) And then there are externality arguments, it being claimed that effective growth in the relevant industries will have important spill-over effects on other sections of the economy.\(^{46}\) Licensing has the perceived advantage over tariffs, the more usual instrument for such protection, that it enables some degree of discretion to be exercised.\(^{47}\)

Of course, there is always a risk that an interventionist strategy in such cases will slide into permanent, rather than, temporary, protection.\(^{48}\) Also protection may provide exactly

---

\(^{42}\) Ogus, above, no. 14; Svorny, above, no. 4.
\(^{43}\) C.D. Foster, Privatization, Public Ownership and the Regulation of Natural Monopoly (Blackwell, 1992), 197–205.
\(^{48}\) Ray, above, no. 44, 674.
the wrong incentives to develop effective industrial and business methods. In any event, the public interest justifications tend no longer to find favour among the majority of international trade economists. It is considered that the problems of externalities can be better addressed by alternative means: firms can be directly compensated for the social benefits which their industrial activity generates. Then to justify the protection of infant industries, it is doubted whether the future benefits (the prospect of more competitive and efficient domestic industries) exceed the welfare losses arising from consumer losses (higher prices) and the administrative costs of the system, particularly as the empirical evidence suggests that they often do not have the desired effect on domestic industries.

4.3. Licensing as an instrument of social regulation

From economic regulation, we turn to social regulation for which information asymmetry is a frequently cited justification. 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. The argument for licensing presumptively applies to some, particularly sophisticated, products as well as professional services and a wide range of non-professional services including, for example in China, overseas education agencies; marriage promotion agencies; job-hunting and recruitment agencies; travel agencies; security service agencies; hotel and restaurant management services. While sellers of higher quality products and services may be motivated to provide relevant information, this may 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. Information which might have been voluntarily given can be the subject of mandatory disclosure obligations enforced by public agencies and, as has already been observed, certification systems effectively provide this form of regulatory protection.

In what circumstances is such mandatory disclose unlikely to prove adequate? We may note, in the first place, that governments may not always trust individuals, with appropriate information, such as that provided by a certification system, 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.

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

---

50 Krueger, above, no. 44; Bell et al., above, no. 46.
51 Although, given the existence of customs clearance procedures, the marginal additional administrative cost of a licensing system at this point may not be large.
developing countries and therefore the stronger will be the case for interventionist, or paternalist, policies. The variety of licensing regimes used in the Chinese agricultural industries to protect vulnerable farmers provides a good example. Analytically quite distinct from this is a second set of circumstances, where the purchasing decision of the consumer significantly and adversely affects third parties: there are negative externalities. Sources of potentially major negative externalities feature prominently among licensing systems including most obviously nuclear, gas and electricity installations, but also many other activities generating risks of accidents (e.g., unsafe buildings), illness (e.g., food and pharmaceutical products) or widespread environmental damage (thus justifying zoning and waste management licences). The argument can be applied to activities which are traditionally associated with crime, such as gaming and the supply of alcohol, and also to the over-exploitation of natural resources, the externality there being imposed on future generations.

We have seen that in many developing countries entry regimes are used for land planning, waste management, building safety and other purposes, even where the business does not involve that particular operation. Our first point is, therefore, that though the externality argument may be regarded as sufficient for licensing, that may justify operation, but not necessarily entry, licensing. Further, in relation to these circumstances, there are often plausible policy responses which fall short of expensive licensing regimes. Most obviously, suppliers can be subjected to merely on-going quality standards, rather than the combination of entry and on-going standards imposed by licensing regimes, and these on-going standards may be the subject of private law obligations and industry self-regulation, as well as public regulatory controls. The crucial differences between these approaches relate to enforcement. Under a licensing regimes 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, we must therefore identify circumstances in which a strategy of mere ex post enforcement may generate correspondingly large welfare losses.56 There are two important dimensions to this task: the size of the potential loss resulting from unlicensed activities; and the effectiveness of ex post systems of deterrence. We deal with these in turn.

First, prevention may be preferred to deterrence if very large losses may result from the unlicensed activity.57 What may be so characterised is a matter of difficult judgement. We should probably include situations where relatively small losses occur, but to a high proportion of relevant transactions. Other candidates include irreversible externalities, such as ecological harm, and certain land use decisions which have long-term consequences.58 Fatal accidents and other major threats of health and safety may be so regarded, particularly where large numbers are involved, and even financial losses may be catastrophically high, relative to the victims’ circumstances.

57 Ogus, above, no. 14, 215.
However, losses of this magnitude are almost never the inevitable consequence of failures of business quality; there is, rather, a risk of such events occurring. We should therefore be suspicious of attempts to justify licensing systems by reference to size of the losses, unless there has been some discounting for the probability of the loss occurring. So, if the additional costs of ex ante scrutiny are represented as $C$, and the amount of loss which such scrutiny would prevent is $L$, then the condition for the licensing system to be justified is $C < PL$, where $P$ is the probability of the loss occurring in the absence of the scrutiny.

There are, of course, problems in arriving at a reliable assessment of the variables involved in this calculation. In general, $C$ is easier to measure than $L$, at least where the latter involves preventing losses to assets (such as the environment, human life, or freedom from illness) which are not customarily the subject of market transactions. Account may also have to be taken of the fact that members of the public do not always take the same approach to risks as experts, and in consequence they may attribute a higher value to $PL$, than is objectively justified, thus enhancing the case for an ex ante, preventative policy. Even if these lay perceptions of risk are manifestly false, it can be argued that they cause disutility which is a genuine cost. On the other hand, adopting this approach without qualification would lead to disproportionate responses and seriously inhibit technological development. If, and to the extent that, attitudes to risk are based on inadequate information or fallacious understanding, it can be argued that the disutility to which these give rise may more easily and cheaply be contained by the better informing and educating of public opinion.

A distinct, but related, issue is that of uncertainty. Much pressure for preventative, rather than ex post, regulation appears to be fuelled by an increasing awareness that many scientific predictions are subject to uncertainty. Policymakers devising regulatory systems may be expected to err on the side of caution when dealing with risks of this kind, but that does not imply that preventative action should be taken wherever there is an uncertain, but perceived, risk of very serious harm, and whatever the cost of prevention. Perceptions must have at least some degree of plausibility; clearly we cannot inhibit all technological process simply because some speculative predictions have been made. And the opportunity costs involved in some licensing procedures may be very high and to some extent overlooked. There are uncertain risks involved in each new pharmaceutical product, thus justifying lengthy investigations prior to the granting of a licence, but the delay in marketing the product may itself generate significant losses of life.

---

59 Economists have devised sophisticated methods of dealing with this problem. For life and human health, see M. Jones-Lee, The Economics of Safety and Physical Risk (Blackwell, 1989); and for the environment, see T.C. Haab, Valuing Environmental and Natural Resources (Edward Elgar, 2002).
The second dimension relates to the capacity of ex post regimes adequately to deter loss-generating behaviour. According to the familiar economic models of law enforcement, deterrence depends basically on the formal sanctions and other losses incurred on the apprehension for, and condemnation of, contravening the relevant private or public law standard, when discounted by the probability of apprehension and determination of liability, exceeding the utility of the contravention to the firm or individual. The two key variables here are the probability of apprehension and condemnation and the size of the sanction and both may be problematic in the context of developing countries.

In general, reliance on private legal remedies and industry self-regulation is likely be problematic in developing countries, given limited access of ordinary citizens to the judicial system, weak enforcement of judicial decisions, and the insufficient establishment of effective self-regulatory mechanisms. A good example of a licensing system designed to combat this problem is provided by the Chinese regime governing sales of land under construction. If there is a sale of an incomplete development, prior to the sale the developer must obtain a permit which authenticates, inter alia, that permission has been obtained for the development, appropriate payments have been made and a proportion of the development has been completed. The aim is mainly to protect purchasers who would have difficulty in obtaining adequate enforcement of judicial decisions against a developer’s opportunistic behaviour, for example, absconding with the purchase price without completing the development.

As regards public regulatory controls, there is first, the probability of apprehension, which is a function mainly of the resources spent on the monitoring of behaviour by public officials and the involvement of third parties (victims of losses and other members of the public) in law enforcement, and the probability of conviction which depends on the effectiveness of the judicial process. 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.

For deterrence purposes, the lower the probability of apprehension and conviction, the higher must be the sanction. One problem here is that traders, particularly in developing countries, may not have the resources to pay large financial penalties and may (with justification) suspect that courts are unlikely to resort to imprisonment as a sanction for regulatory contraventions. The same may apply if courts are given the power to deprive the trader of the right lawfully to engage in the activity, what we earlier referred to as “negative licensing”.

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.

---

67 There is no such licensing regime for sales of complete developments, perhaps because Chinese legislators think that here purchasers bear less risk of opportunistic behaviour by developers—at least they can recover the losses by seizing the fully-developed property.
68 The Urban Real Estate Administration Act of the People’s Republic of China (1994), art. 44.
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.\(^{69}\) There is evidence of large numbers of unlicensed traders operating in the informal economy in some countries.\(^{70}\) To constrain the losses from such activity, resources must be made available for policing and monitoring,\(^{71}\) 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 the absence of empirical data, it is difficult to reach definitive conclusions on whether licensing regimes can be justified on public interest grounds. Some of the special regimes we have listed for industrialised countries, for example those governing bowling alleys, florists, hairdressers, tobacconists, ice cream buyers, milk vendors and astrologers, would seem clearly to fail to satisfy the criteria.

As regards developing countries, much depends on how the enforcement arguments, vital to the analysis, are resolved. In the absence of empirical evidence, we suspect that, in many jurisdictions and in many situations, there would be efficiency gains if the administrative resources currently used in ex ante licensing regimes were to be transferred to selective monitoring and enforcement of ex post regimes. If that hypothesis is correct, then large areas and large numbers of licensing regimes currently operating in developing countries would fail to satisfy the public interest criteria. Even if the hypothesis cannot be sustained, there are clearly many regimes which it would be difficult to justify on public interest grounds. Among those we have listed for the People’s Republic of China, we would place into that category those governing restaurants, and the processing and trading of gold, silver and cashmere wool.


\(^{71}\) In the Philippines, all businesses must obtain a “master” licence from the local mayor’s office. This is designed, inter alia, to ensure that firms have obtained all the necessary activity licences and paid all licensing fees before commencing trading. See: http://trw.worldbank.org/DongBusiness/TopicReports/EntryRegulations-Summary.aspx?regionid = 153. The system might generate scale economies in policing the existence of multiple licences. See C. Abuodha and R. Bowles, “Business licence reform in Kenya and its impact on small enterprises”, (2000) 11 \emph{Small Enterprise Development} 16. But it adds a further barrier to entry which itself, to be effective, must be policed.
5. Revenue-raising explanations for entry controls

Licensing regimes can be used to raise revenue. Raising revenue by taxation is necessary in all countries and therefore can obviously be regarded as in the “public interest”, but of course the way the proceeds are used is not always consistent with public interest criteria and the level and mode of exacting revenue may seriously distort the economy. We therefore place revenue-raising explanations in a separate category.

It is clear that many developing countries, particularly in Anglophone Africa, use entry controls primarily as taxation instruments, often for local government purposes. 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. Revenue-raising may, therefore, provide a good explanation for the existence of regimes which are difficult to justify on public interest grounds and/or which are not applied in practice for those purposes. One author puts the matter succinctly, “a licence ordinance which does not require inspection of the business or the articles sold, or fails to regulate the conduct of business in any manner, is a pure revenue licence, particularly if the licence applications are never denied”.

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.

6. Private interest explanations for entry controls

If it is difficult to justify a given licensing regime by reference to public interest considerations and it is not used for revenue-raising purposes, how is its existence to be explained? A considerable literature suggests that much regulation is created to further private interests.

---

73 Devas and Kelly, above, no. 10.
75 The theories and literature are surveyed in Ogus, above, no. 14, Chapter 4.
and there are many studies which purport to show that specific licensing regimes benefit particular interest groups. We need to explore this latter hypothesis, to ascertain what private interests may be served by entry regulation in both industrialised and developing countries.

First, and most obviously, we can look to the interests of existing suppliers within the relevant market. Entry controls impose costs on those seeking to enter and compete with existing suppliers, and the more restrictive the conditions of entry, the higher the costs. The costs reduce the number of suppliers and thus consumer choice; they may also lead to increases in prices and the profits (rents) earned by existing suppliers. These latter effects depend on the availability of substitutes goods and services in the market: the less willing consumers are to shift demand to such substitutes, the higher the price increases and the profits to suppliers.

In relation to the supply of professional services, it is easy to see how those who may thus benefit from significant barriers of entry may succeed in pushing the law in this direction. The professions are typically able to organise themselves at relatively low cost into homogenous and therefore effective pressure groups, capable of exerting a considerable influence on government regulatory policy. And, of course, many areas of professional regulation are governed by self-regulation, the leading members of the profession then being able themselves to formulate and enforce the entry controls. Suppliers of non-professional services and products do not normally have these advantages and therefore in their case the private interest explanation of entry controls is less plausible. However, they may be able to harness their demand for regulation to that of more powerful groups, for example, those representing consumers, who think that they will benefit from stricter controls.

In developing countries, the market may be dominated by relatively few, but powerful, incumbents, including state-owned enterprises, which can obtain government support in establishing and exploiting to their advantage licensing requirements.

Secondly, we can investigate the interests that politicians and public officials may have in entry controls. In the broadest sense, widespread regulation of market entry implies a large degree of government control over the economy as a whole, and it is therefore the antithesis of the notion of freedom of economic activity which is supposed to lie at the heart of modern state practice and which in many jurisdictions is enshrined in the constitution. As such, control of market entry has deep historical roots, being deployed particularly during periods when rulers wanted to enhance their power by maintaining hands on key

---

76 Surveyed in Sörényi, above, no. 4, 309–314.
77 Existing suppliers are often exempt from new, more stringent, conditions of entry by so-called “grandfather” clauses: W.D. White, “Dynamic Elements of Regulation: The Case of Occupational Licensure”, (1979) 1 Research in Law and Economics 15.
78 Sörényi, above, no. 4, 301.
80 Faure et al., above, no. 29.
81 Ogus, above, no. 14, 229–230.
As regards developing countries, the historical context is also important. Many of these countries inherited their basic legal and regulatory infrastructures from colonialist periods. Now the colonialist powers were certainly concerned to control the local economy, whatever may have been the prevailing ideology in the home country, and regulating entry was one obvious means of doing this. Independence did not lead to an end to this approach. Indeed, rather the reverse: the new rulers were concerned to consolidate their economic and political power by preserving and even enhancing legislation requiring official permission to engage in commercial and industrial activities, “vesting very considerable discretion in ministers and officials, with few standards for its exercise”.87

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. Such systems normally require significant manpower resources and thus can further the employment prospects of officials, at least those without tenure. It has also been suggested that bureaucrats are motivated to maximise the budget allocated to their office, on the assumption that this would enhance their prestige and generate more agreeable working conditions.89 The hypothesis can easily be applied to licensing systems, since these necessitate a large amount of resources.

Distinct from, but connected to, these motivations is the important issue of corruption.90 This is particularly widespread in developing countries, but it also features significantly in some industrialised countries.95 Although it is difficult to demonstrate the precise causal relationship between excessive regulation and corruption, there is strong empirical evidence

---

85 Ogus, above, no. 83, 8.
88 For general accounts of these issues, see W. Niskanen, Bureaucracy and Representative Government (Aldine, Atherton, 1971) and A. Breton and R. Wintrope, The Logic of Bureaucratic Conduct (Cambridge University Press, 1982).
89 See the references cited in no. 88.
91 See the corruption rankings recorded in Transparency International, 2002 (available at http://www.transparency.org/cpi/2002/cpi2002.en.html) based on perceptions of the degree of corruption as seen by business people, academics and risk analysts. Although, in general, industrialised countries rank above developing countries, Singapore (5th), Hong Kong (14th), Chile (17th) and Botswana (24th) come ahead of France (25th), Italy (31st) and Greece (44th) in terms of freedom from corruption.
that the two phenomena are related, presumably because regulatory decision-making creates opportunities for exacting bribes. 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. Chinese studies reveal that corruption is particularly concentrated in the public offices dealing with business licences.

Insofar as the private interests of politicians may gain from the imposition of business entry controls, it is not difficult to see how they can advance their cause through legislation and other regulatory measures. On the Weberian model of bureaucracy, usually adopted in industrialised countries, public officials have less direct involvement in the law-making process and they should implement but not influence government policy. However, in practice they play a key role in the policy process. They are generally asked to explore policy options and, given their control over information, can then be selective in what is put on the political agenda. In developing countries, the distinction between politicians and administrators tends to be more blurred and an alliance between the ruling elite and high-ranking officials has often resulted in an “oligarchy of power and privilege”.

Hard conclusions should not be drawn from this survey of private interest theory. Rather, it should lead us to offer plausible explanations for the proliferation of entry controls in circumstances where public interest justifications are weak. In the context of developing countries where principles of accountability may not be strong and where there is a tradition of exploiting public institutions for private gain, that hypothesis may be particularly important.

7. Conclusions

In this paper, we have investigated the use of licensing as a regulatory instrument in developing countries. Our principal aim has been to explore to what extent systems of licensing can be justified by public interest considerations.

We are reluctant to make generalisations about the systems, because the information available on their operation is limited. Our focus is rather on whether the selection of entry control, as a regulatory instrument, seems appropriate to the circumstances affecting developing countries. Our analysis suggests, first, that registration systems will often be appropriate both to reduce the costs of public administration and, within reasonable limits, as a device to raise revenue. However, the failure in many countries to avoid the proliferation of such systems by use of “one-stop” shops suggests that private interest explanations should not be ignored.

Secondly, in comparison with industrialised countries, the use of licensing systems in developing countries is more widespread, in terms both of scope and of frequency. The

92 Djankov et al., above, no. 6, 26–27.
most plausible explanation is that in many developing countries an adequate infrastructure for the monitoring and enforcement of ex post systems of regulatory control does not exist. As a public interest justification, this seems to rest on the key assumption that, given limited administrative resources available for regulatory purposes, these are more efficiently allocated to universal scrutiny at the ex ante stage combined with periodical renewal, rather than to selective monitoring and enforcement at the ex post stage. We suspect that in many situations that assumption is unlikely to be valid, although there is a need for further investigation of this. In any event, there are efficiency gains to be made by converting some entry licensing systems to operation licensing.

Thirdly, there are very large differences between special licensing regimes for particular industries and activities in both industrialised and developing countries. While some of these differences may be justified because the size of negative externalities and of information problems arising from given activities varies according to local culture and the level of economic development (and therefore education), as evidenced by our selected examples drawn from the People’s Republic of China, some of the regimes are hard to rationalise on this basis. They seem rather to be the consequence of private interest influence, the barriers to entry protecting incumbents, or else relics from state-controlled economic systems which continue to benefit officials and politicians.

Acknowledgment

We have much benefited from comments made by an anonymous referee and participants at workshops at the University of Hamburg and the University of Illinois, Urbana-Champaign.