

# U4 Expert Answer



## Integrating anti-corruption measures in the design of public law enforcement / regulatory agencies

### Query

**When establishing new public law enforcement agencies or regulatory bodies in Georgia – for example competition agencies, sanitary and phytosanitary regulatory agencies etc. – how can donors make sure to include anti-corruption measures in their design? Please give some examples of best practices.**

### Purpose

The purpose of this query is to provide examples of best practices for the integration of anti-corruption in the design of new public law enforcement / regulatory agencies. This information was requested due to the need to establish new regulatory agencies in Georgia to fulfil EU requirements for deep and comprehensive free trade agreements.

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### Summary

Agencies tasked with regulating business and ensuring the functioning of markets help devise and enforce rules and regulations related to a broad range of issues. These include safeguarding product safety and consumer protection to ensuring market stability and transparency, equitable access to infrastructure, fair competition, or security of supply. Along with this important remit as rule-makers, guardians and arbiters, regulatory agencies can become lucrative targets for undue influence and other forms of corruption.

This expert answer first charts some of the corruption risks that regulatory agencies face, discussing remedies suggested in the literature. A focus is placed on regulatory agencies in general, rather than sector-specific agencies. It is found that ensuring independence, autonomy and accountability of regulatory agencies are the most crucial components to mitigate corruption risks.

The final section of the query describes some features of the OECD Regulatory Impact Analysis initiative as an example of an international best practice mechanism that provides guidance on building effective and robust regulatory agencies with low corruption risks.

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## 1 Introduction: Brief overview of the regulatory context in Georgia

In recent years Georgia has undergone massive deregulation that either closed down or reformulated the mission of public regulatory agencies across many sectors of the economy. While these interventions may have helped to stimulate economic growth, concerns about unfair competition, poor product safety and lack of consumer protection have also surfaced.

While a systemic evaluation of the extent of these problems could not be found, anecdotally many news stories suggest that major monopoly bottlenecks exist in the economy. For example in 2008 an Israeli pharmaceutical importer alleged that it was denied an import license by the Drug Agency, leaving the market solely to the few established importers. (Transparency International Georgia, *Competition in Georgia*, 2009)

In the phyto-sanitary sector, the lack of regulation materialises starkly in terms of threats to human health. For example, currently the rate of botulism in Georgia is the highest in world. The rate of diarrhoeal diseases is a third higher than that in the EU and the situation is deteriorating at an alarming pace with bacterial food poisoning rates rising rapidly (Transparency International Georgia, *Food Safety in Georgia*, 2009).

Under these circumstances, most experts agree that establishment of effective regulatory agencies is a priority for Georgia. In fact, a recent European Commission study, found that Georgia's

“current legal and institutional framework does not provide for a solid basis for an effective competition policy.”

(Livny, E. & Shelegia, S., 2007)

Corruption can severely undermine regulatory efforts. In fact, experts have argued that the situation can be particularly vulnerable to corruption after economic reforms and transition to free market economies. New institutions are being built and remain untested, new public-private interfaces are created, the application of new regulations may still be unclear, there may be overlapping competencies between government agencies, and a lack of experience and expertise in dealing with the new situation and regulating markets effectively (Gülen, G. et. al, 2007).

This means Georgia is in a critical phase of building and consolidating regulatory agencies, which will shape the fundamental structure and functioning of markets and business sectors.

The following section outlines some of the major corruption risks in the operation of regulatory agencies and suggests some good design principles that can help mitigate these risks.

## 2 Corruption risks in regulatory agencies: Issues and safeguards

The discussion on market regulation often tends to focus on the formulation of related laws, international harmonisation and best practices in implementation. However, not much material was found that deals specifically with corruption risks at the operational level in the functioning of regulatory agencies. A review of the available research suggests that in order to integrate anti-corruption into the design of regulatory agencies, policymakers primarily need to consider the overarching issues of independence, autonomy and accountability. Some corruption risks in achieving these goals and some possible remedies are described below:

### *Independent and autonomous regulatory agencies*

In order to ensure effective and robust regulatory agencies, the World Bank stipulates that they need to be aided by the following mechanisms:

- Vested with a distinct legal mandate
- Professional criteria for appointment
- Involvement of both executive and legislative branches in appointments
- Sound human resources practices such as fixed terms for senior staff with protection from arbitrary removal
- Staggered terms of appointment
- Reliable funding

To be autonomous, regulatory agencies need to have their own resources, ideally generated through ring-fenced funding sources or income generating

mechanisms such as service fees. Sole reliance on budgetary allocations controlled by politicians is often viewed as a threat to regulators' independence. For example, funding can be raised through levies on the regulated firms or consumers of the regulated services. Experts have pointed out that autonomy needs to go beyond financing. Regulators should also have autonomy in human resource decisions. For example, they should be able to recruit staff with high levels of expertise; the tasks of the agency should determine the size of the staff, not political considerations such as the number of people who have lost their jobs through privatization (Estache, A., 1997).

However, while autonomy can mitigate the political capture of the regulatory agency, it does not fully guard against corrupt side-agreements between regulators and firms. The corruption literature indicates that discretion and informational advantages that come with more autonomy can result in an environment where corruption can flourish if no other accountability measures and checks and balances are introduced. The design of regulatory frameworks thus has to take this into account.

Carefully defining the remit and approach of the regulator and thereby putting clear well-reasoned boundaries around its discretion helps reduce incentives for firms to exert undue influence, since the regulator will find it difficult to step outside its remit (Boehm, F., 2007).

The World Bank suggests an additional set of accountability and transparency measures that further safeguard against corruption risks. These include:

- Rigorous transparency, including open decision-making and publication of decisions and reasons for those decisions
- Appeals process
- Scrutiny of the agency's budget, usually by the legislature

(Smith, W. 1997)

### *Transparency and access to information*

Corruption breeds in opacity - in a world of perfect information there would be few possibilities to bias or circumvent existing rules in order to derive benefits for personal gain. Anti-corruption policies in regulation thus have to aim at reducing informational asymmetries and

enhancing transparency. Since a certain degree of discretion is unavoidable and necessary in regulation, introducing transparency, collecting data on operations and performance and ensuring accountability are essential components of anti-corruption efforts.

Comprehensive information is needed on the following levels:

1. **Between government and regulatory agency** – The regulator has more information about the regulated firms than the government which can make it easier to collude with regulated entities. Regulatory staff may also defraud the government and embezzle funds. Transparency measures thus have to focus on information about how decisions are taken and on what reasoning and information they are based. For example, experts have suggested that in the case of decentralised regulation, a central agency responsible for all sectors and regions could be implemented thereby hampering capture at lower levels. (Boehm, F. 2007)
2. **Between regulated firm and regulator** – The Enron case has demonstrated that effective regulation can be avoided and fraud becomes possible when firms have a considerable informational advantage over the regulator with regard to their cost structure, financial arrangements and technical operations. The firm can provide incomplete or misleading information and manipulate its books in order to gain favourable treatment. Narrowing this information gap and expanding the information that firms need to make available to the regulator has therefore positive effects and diminishes the risk of abusing monopoly positions. It may also reduce the risk of other dubious behaviours, such as creative accounting, cost shifting, false invoicing etc. Improving information on this level makes detection easier and strengthens deterrence.
3. **Between users/civil society/media and regulator/government/firms** - Although they one of the most important stakeholders, consumers are usually not well-informed about the details of regulation and in many instances are completely left outside the formal regulatory processes from devising rules to enforcing them. Civil society groups and the

media are also often not able to access required information concerning regulatory issues and therefore cannot provide important additional scrutiny for regulatory decisions.

4. **Within the regulatory agency between experts and non-experts** - Informational asymmetries within the regulatory institution are not frequently discussed in the literature. For example, there are considerable informational asymmetries between experts and non-experts, in particular regarding financial information and accounting data. There may also be asymmetries regarding technical issues that require engineering expertise. Such types of informational asymmetries may also arise if one individual regulator is responsible for a certain project in relation to a firm. During his work, he can collect valuable information which is only known to him. Other regulators might not have the capacity to oversee the details of the work carried out by the expert. This informational advantage can be abused to collude with firms, selectively disclosing or even falsifying information in exchange for favours, bribes or future job offers in the private sector. Reducing these types of asymmetries is very difficult, but some useful measures include frequent rotation of experts through different cases, as well as ensuring that dockets are well-documented and decisions are traceable and verifiable. The possibility of external, unannounced expert reviews can further help deter corruption in these contexts. (Boehm, F., 2007)
5. **Among (competing) regulated firms** - Regulated firms in a more or less competitive environment (for example telecommunications or energy) can be trapped in a kind of prisoner's dilemma where one single firm does not know whether competing firms resort to corruption as a strategy for strengthening their position in the market. In such a context, other firms may be induced to level the playing field by also resorting to corruption. Access to information is crucial to prevent such situations and build trust in the integrity of competitive practices. Voluntary codes of conduct and other private sector initiatives can play an important role to build trust and promulgate integrity. Integrity Pacts and Sectoral

Agreements are means to avoid such prisoners' dilemmas by inviting all parties to commit to clear anti-corruption and integrity practices, preferably monitored by a civil society organization with access to information (Boehm, F. & Olaya, J., 2006).

### *Staff Incentives*

Anti-corruption measures in the design of regulatory agencies can play a big role in motivating honest behaviour by staff.

Human resources practices to reduce incentives for corruption include:

- Small and specialized agencies
- Reducing the difference between private and public sector payments
- Hiring well-trained staff and offering the perspective of ongoing training, for example through contact with universities
- Information sharing and building networks with regulators from other countries during regular conferences and workshops
- Conscience-building regarding social objectives and the importance of regulation
- Good working conditions

(Boehm, F., 2007)

All these measures help raise job satisfaction, strengthen commitment to integrity principles and raise the costs of job loss when corruption is detected. Taking a cue from anti-corruption agencies, regulatory agencies can also undertake staff training on integrity. It can be envisioned that agencies have their own internal oversight body to investigate breaches of its code of conduct, or a body that monitors and reviews all complaints held against the agency (Please see: U4 Expert Answer, *Anti-Corruption Agencies: Staffing and Financial Management Issues*).

Experts have pointed out that positive incentives for honest behaviour need to be combined with sanctions and control. Both internal and external control mechanisms have to be established to augment the risk of detection. Clear rules need to be established regarding the sanctions to be expected in the case of

detection of an action that goes against the rules and objectives of regulation. Sanctions can entail a public or criminal lawsuit ending in monetary fines or even a prison sentence, loss of public office and forfeiture of the right to apply for other public offices (Boehm, 2007).

### *The role of audits*

In order to minimize risks of fraud, both internal and external audit mechanisms are needed. Accountability must be facilitated through clear and transparent documentation and internal auditing procedures. Clear and standardized rules of behaviour have to be introduced in day-to-day business with well-defined responsibilities.

External control of the regulatory agency by independent auditors is also important. External controls on an irregular basis are often more effective and more resistant against collusion between auditors and audited institution than regular and institutionalised controls.

'Soft' external control by interested third parties has proven to be a good way to apply additional scrutiny to regulatory bodies. Ensuring that a broad range of different stakeholders can follow and participate in the process provides checks against capture and leads to a fairer outcome of regulation. The provision of detailed information by the regulator to interested third parties is of pivotal importance for the working of external controls by civil society groups, media, and even individual market participants or consumers. However, accessible, relevant, and accurate information is only a necessary but not a sufficient condition for accountability. Citizens and watchdog bodies also need political and financial capacity and resources to exercise that right effectively. (Boehm, 2007)

### *Prevention of conflicts of interest and revolving doors*

Detecting and managing conflicts of interest can help reduce incentives for corruption. Further, a transparent handling of conflict of interest situations permits the regulator to publicly commit to his anti-corruption strategy. The OECD has developed a toolkit helping to identify potential conflicts of interests between public duty and private interests, which can be consulted and applied in regulatory institutions (OECD, *Managing Conflict of Interest in the Public Service*).

The revolving door between the private and public sector (individual moving too smoothly between jobs at the regulator to positions on the side of the regulated

entities and vice versa) also requires attention. Regulators are usually barred from working for the private industry they have regulated for a certain period of time. This disqualification should be long enough in order to hamper the formation of corrupt deals. A study in Columbia found that private sector experts were regularly hired to work on a contractual basis for regulatory agencies. Such experts were not considered to be civil servants and they could switch between the regulator and the regulated industry and vice-versa without cooling-off periods. This can open up great opportunities for conflicts of interest. Hiring practice needs to discourage habitually contracting experts from the regulated sector. Instead, adequate staffing should be envisaged and the independence of external experts should be considered in the outsourcing process (Boehm, F. 2007).

### *Encourage whistle blowing*

Many corrupt arrangements are brought to light by whistleblowers and these reporting practices need to be encouraged and protected from retribution. Corrupt actors or persons having information about corrupt deals, who wish to denounce the deal, for example, to ombudsmen or prosecution agencies, can be encouraged to blow the whistle through at least partly attenuated punishments. It is even possible to envision rewards for whistleblowers, which would introduce a high degree of risk into corrupt deals from the beginning.

Further, whistleblowers have to be offered effective protection (for example, through witness protection programs), especially in regions where corruption is linked to organized crime or paramilitary groups (for a guide to effective whistleblower protection regimes, please see: Transparency International, *Alternative to Silence: Whistleblower Protection in 10 European Countries*).

### *Rotation of regulators and team visits*

By changing the persons who are in contact with staff from regulated firms on a regular basis, two effects are enhanced. First, the information concerning the firm is divided between various regulators, thereby diminishing the informational asymmetry within the regulatory institution and thus the scope for abuse and collusion with managers from the firms. Second, the establishment of close relationships is prevented, and thereby the possibilities of the initiation of corrupt deals. Rotating regulators in contact with regulated firms hampers not only the formation of corrupt deals but also their enforcement - by preventing establishment of

close relationships and dependencies which could serve as enforcement mechanisms.

Regulated firms or meetings should always be visited in teams of at least two regulators, and if possible in rotating teams. Corrupting multiple officials entails a higher risk, not only during contract initiation, but also during the enforcement of the deal, multiplying the risks of being caught (Boehm, 2007).

### *Anonymity*

Anonymising (where possible) relationships between regulators and regulated firms can further reduce the influence on decision-making of the cultivation of close relationships between regulator and regulated company. Anonymity in decision-making processes will also curtail efforts on the supply side of corruption since regulated firms will not know who to approach (Boehm, 2007).

## 3 International best practice example: OECD Regulatory Impact Analysis

Several international initiatives have produced lists of (often sector-specific) best practices for the effective functioning of regulatory agencies. In the field of anti-trust regulation, guidance on encouraging international harmonisation in the creation and implementation of antitrust best practice is provided by the Organisation for Economic Cooperation and Development (OECD), through its Competition Law and Policy Committee; the United Nations Conference on Trade and Development (UNCTAD); and the International Competition Network (ICN). (Please see: OECD, *Competition Law and Policy*; UNCTAD, 2002; ICN, *The Handbook of Competition Law Enforcement Agencies*).

A major international effort to establish best practice for regulatory agencies across many sectors is the OECD Regulatory Impact Analysis (RIA) initiative. RIA is a systemic approach to critically assessing the positive and negative effects of proposed and existing regulations and non-regulatory alternatives. One of the stated aims of RIAs is to build a regulatory management system – to regulate the regulators through transparency and accountability mechanisms (laws, policies, institutions, enforcement). The systematic conduct of RIA underpins the capacity of OECD governments to ensure that regulations are effective and efficient.

In May 1997, ministers of OECD countries endorsed the recommendations in the OECD Report on Regulatory Reform, which includes a recommendation that governments “integrate RIA into the development, review, and reform of regulations.” The number of OECD countries that require RIA of new regulatory proposals has grown to 26, and some form of RIA has now been adopted by nearly all OECD members (OECD, Regulatory Impact Analysis).

RIAs aim to comprehensively look at entire regulatory regimes and are not designed to deal specifically with corruption issues. However, some of the measures suggested work towards addressing corruption risks identified in the literature. In fact, the RIA model has been used in countries such as Uganda for anti-corruption purposes (OECD, 2004).

The OECD has established a list of RIA best-practices, some of which are highly relevant to anti-corruption efforts. These include:

1. Maximising political commitment to RIAs by:
  - a. Endorsement at the highest levels of government
  - b. Supported by clear ministerial accountability
  - c. Integrate RIA into the policy process by attaching RIA to legislation and ensuring quality control
2. Allocate responsibilities for RIA programme elements carefully by:
  - a. Decentralisation to ministries and regulators to favour ‘ownership’ and integration into decision-making
  - b. Central unit functions such as managing RIA process, training and guidance for RIA drafters and advocating reforms
3. Use a consistent but flexible analytical method to include:
  - a. Qualitative vs. Quantitative analysis
  - b. Benefit-cost analysis
  - c. Risk assessment
4. Develop and implement data collection strategies and implement evidence-based training
5. Integrate RIA with the policy making process as early as possible
6. Involve the public extensively in all stages of the process

7. Communicate the results – This improves transparency and accountability, and helps ensure regulatory compliance
8. Train the regulators - A vehicle for a cultural change for regulators, which typically include ethical training.

(OECD, 2003)

Consultation, participation and transparency are the cornerstones of RIA. The systematic integration of stakeholders' views enhances RIA quality by inviting comments from people that will be affected by the regulation. It also helps improve compliance, as the ownership of the proposed regulation is shared with stakeholders. The public, especially those affected by regulations, can often provide much of the data needed to complete the RIA. Consultation can provide important information on the feasibility of proposals, on the alternatives considered, and on the degree to which affected parties are likely to comply with the proposed regulation. Furthermore, the assumptions and data used in RIA can also be improved if they are tested after the carrying out of the RIA through public disclosure and consultation.

RIAs also recommend strong monitoring and evaluation. At the final stage of the policy process, after the regulation is operational, it is recommended that RIA processes include an evaluation of whether regulations are operating in the manner that was expected. By strengthening the transparency of regulatory decisions and their rational justification, RIA strengthens the credibility of regulatory responses and increases public trust in regulatory institutions and policy makers

(OECD, 2003).

## 4 Further reading

Slaughter and May, 2009, Commission Publishes Best Practices to Improve Transparency and Predictability of Antitrust Proceedings

[http://www.slaughterandmay.com/media/900752/eu\\_competition\\_newsletter\\_18\\_dec\\_09\\_-\\_08\\_jan\\_10.pdf](http://www.slaughterandmay.com/media/900752/eu_competition_newsletter_18_dec_09_-_08_jan_10.pdf)

Sokol, D. 2009, *The Future of International Antitrust and Improving Antitrust Agency Capacity*

<http://www.law.northwestern.edu/lawreview/v103/n2/1081/LR103n2Sokol.pdf>

U4 Expert Answer, 2007, *Criteria for appointing executives of anti-corruption agencies*

<http://www.u4.no/pdf/?file=/helpdesk/helpdesk/queries/query122.pdf>

The criteria selected to appoint executives of anti-corruption agencies should ensure high standards of integrity and independence of nominated candidates. As the appointment and removal process of officeholders may have a direct impact on the independence of the body, the appointment procedure should be transparent and involve a broader range of actors than those currently in political power. Recruitment procedures for non-executive staff should similarly guarantee staff integrity and competence, regulation of appointments and dismissals as well as adequate salary levels.

U4 Expert Answer, 2006, *Anti-corruption prosecutorial agencies: effectiveness and funding modalities*

<http://www.u4.no/pdf/?file=/helpdesk/helpdesk/queries/query121.pdf>

The funding modalities of investigative and prosecutorial agencies may lend themselves to potential for political manipulation and interference. This U4 Expert Answer analyses the independence, source of funding and course of anti-corruption prosecutions undertaken in Vietnam, Korea and Nigeria and provides information on anti-corruption agencies in Guatemala and Montenegro.

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