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Reforming Inspections

Jacqueline Coolidge

Jacqueline Coolidge (jcoolidge@ifc.org) is a lead investment policy officer at FIAS World Bank-IFC.

Countering Corruption and Waste

Government inspections of firms are important for enforcing regulations to protect public health, safety, and the environment and to carry out economic functions such as tax collection and banking regulation. But most inspection regimes in developing countries impose excessive costs on firms while failing dismally to prevent accidents or mitigate losses from disasters. There is a strong interest in models of reform that will reduce the burden of government inspections while improving standards. This Note offers solutions that do both.

Firms in many countries complain about tax inspectors who harass businesses and threaten to freeze their accounts, building inspectors who demand compliance with meaningless regulations and cause delays in business start-up, sanitary inspectors who interpret requirements inconsistently and favor cronies and bribers over their competitors, and environmental inspectors who extort bribes rather than enforce needed controls (box 1).

Many governments too see a need for reform. Tragic and avoidable losses resulting from workplace fires, industrial accidents, and the collapse of buildings during earthquakes or other disasters have led them to conclude that their inspection regimes are not living up to their mandates.

The World Bank's annual *Doing Business* reports have shown that businesses in many developing and transition economies still face

very burdensome procedures for licensing and inspections. Obtaining the permits and inspections for constructing a simple warehouse takes more than a year in Bosnia and Herzegovina, Brazil, Cameroon, the Islamic Republic of Iran, Nigeria, the Russian Federation, and Zimbabwe—but only two to three months in many industrial countries and about four to five months in Jordan, Mauritius, Panama, and the Baltic countries (World Bank 2005, pp. 95–97). Why a year when two to three months will do?

What are the keys to successful reform?

Experience in reform of government inspection regimes suggests six key lessons.

Be comprehensive rather than piecemeal

Most inspections reforms achieving sustained success have been broad programs covering most inspectorates dealing with businesses.



Box The burden of inspections

I Where inspections seem arbitrary or unfair, they can appear particularly burdensome. In the 1990s businesses in the Russian Federation sometimes faced conflicting demands from fire inspectors, with federal inspectors requiring that fire extinguishers be placed 1.45 meters from the floor and municipal inspectors demanding that they be hung at 1.35 meters. Businesses learned to keep two hooks on the wall, switching their extinguisher from one to the other depending on which inspector showed up. In 2000 an entrepreneur in Lithuania complained that she had been heavily fined by tax inspectors for moving her cash register from one room to another without obtaining prior permission. And in Azerbaijan sanitary inspectors have been known to accept a bribe from an established company to find a pretext for shutting down a new competitor.

These comprehensive reforms often include governmentwide programs to improve the drafting of regulations, better assess their impact, and enhance monitoring and accountability.

Piecemeal reforms in one or a few inspectorates can be useful, short-term palliatives, but they tend to be vulnerable to backtracking and reversals, such as when there is a change of government. Worse, where governments suffer from entrenched, systemic corruption, high-level officials cut off from one source of revenue will quickly turn to another—such as by switching from worker safety inspectors to fire inspectors.

For example, inspections reforms in Russia merely limiting an inspectorate's planned inspections of a business to one every two years did nothing to halt unplanned inspections, demands for bribes, or illegal "fines." The reforms could have been strengthened by adding outcome-based performance indicators for inspectorates (such as reductions in the incidence of workplace fires), risk-based selection of firms for inspection, and greater accountability for inspectors.

In the Philippines attempted reforms of customs inspections aimed at improving collections (by introducing third-party certification and risk-based selection of inspection targets) fell short of even the primary goal of increasing net revenue. The reason? The government failed to

put into place broader reforms to ensure accountability for achieving objective performance measures (such as higher revenue and lower costs). A lack of political will to ensure accountability at the highest levels of the Customs Administration led to backtracking as early improvements (including a smaller share of shipments subject to full inspection) evaporated over time.

Contrast these results with those of inspections reforms linked to broader programs of regulatory reform. In the Netherlands a new approach to regulatory compliance was aimed at improving outcomes while simultaneously reducing costs for both government and business. To maximize effectiveness, the government uses a list of "compliance indicators" to tailor the compliance strategy to each area of business regulation. Those likely to involve a high degree of self-enforcement (such as workplace fire safety) usually require fewer mechanisms of control or sanctions. Conversely, where self-enforcement is not realistic (as in tax compliance), a targeted inspection strategy and the possibility of sanctions may be required to ensure adequate compliance.

The government also introduced self-inspection in place of many government inspections. That enabled the ministry responsible for maritime safety, for example, to greatly reduce the administrative burden on shipowners. The ministry simplified detailed reporting and inspection requirements and made the shipowner, not the inspector, responsible for safety. These reforms reduced the number of ships needing inspection and the number of follow-up investigations required—without affecting such outcomes as the incidence of shipping accidents. And they reduced administrative costs for shipowners by about 80 million euros a year. Most other inspectorates saw similar improvements.

Mexico's inspections reforms were also supported by broader legal and institutional reforms—to clarify objectives, train inspectors, develop a compliance policy, introduce risk-based selection of inspection targets, and the like. The inspections reforms have largely achieved their goals, and the success has been sustained for several years.

The course of reform can vary, however, with a relatively modest inspections reform sometimes serving as the starting point for broader regulatory reform. In Latvia an initial cabinet instruction to improve transparency and accountability in inspections in 1999 led to a much broader law on administrative procedures in 2001, which in turn strengthened and deepened the inspections reforms. These reforms shortened the average duration of key inspections from 6–12 hours to 2–5 hours by 2003, reduced the frequency of inspections, and improved their quality as perceived by businesses—all with no deterioration in outcomes. While the inspections reforms happened to be a starting point, the principles were seen as applicable to business regulation across the board, and supportive of the government’s efforts to improve governance and accede to the European Union.

Focus on ends, not means

Most inspectorates cling to an outmoded and inefficient reliance on punishment as a deterrent for noncompliance: Tell the business what to do and fine it if it fails to comply. Moreover, many governments are too “loose” on the objectives of their regulatory and inspection regime and too “tight” on the regulations, failing to allow for new materials, processes, or technologies that may be more efficient than old ones. That results in regulations that are overly detailed, rigid, and prescriptive (such as requiring that buildings’ walls be at least 20 centimeters thick or that packaged food contain a specific amount of a specific preservative)—encouraging a myopic focus on the means rather than the far more critical objectives (ensuring that buildings can withstand earthquakes of a certain magnitude or reducing outbreaks of food poisoning to below a realistic threshold).

Consider the example of Canada. In the early 1980s many government agencies justified their regulations and related inspections by reference to a law that was itself often vague or flawed. As part of the regulatory reform program, the government required all ministries and agencies to clarify and publicize the objectives of their regulations. That led, for example, to a decision to consolidate several agencies involved in food

safety inspections into a single program, eliminating redundant inspections and clearing up confusion about priorities and strategies for ensuring compliance. That in turn helped to significantly reduce costs while avoiding any deterioration in outcomes.

Use risk-based analysis

Risk assessment techniques can increase the efficiency of inspection programs by helping to identify high-priority problems (such as industries vulnerable to toxic waste spills), determine the probability that a business may be out of compliance (such as one that might be tempted to underreport revenue for tax purposes), and estimate the probability that an offense will be detected during an inspection (such as in industries prone to hiring illegal aliens). Variables like these can be used to target inspections where they are most likely to find serious infractions, helping to reduce costs and improve overall compliance.

Among developing countries, Mexico is one that has successfully introduced risk-based inspection as part of a broader program of regulatory reform. Its customs service supplements a small number of random inspections of shipments with risk-based inspections triggered by such factors as the type of goods declared (those that can be easily smuggled or have been smuggled in the past), new importers without previous records, customs brokers with dubious records, and strategic sectors. The time to clear a shipment at the Mexico City airport has fallen from up to three days to an average of only 20 minutes even as the volume of trade has grown enormously.

Rely on alternative inspection mechanisms

Relying on alternatives to government inspections can yield big savings for the government and lighten the burden on businesses. Alternatives can include mandatory self-inspection (as with maritime safety in the Netherlands), outsourcing (such as the use of licensed customs brokers in Mexico), and third-party certification (as with forestry certification in Canada). In all these cases some government inspections still take place as a backup to and a check on the alternative inspections.

Make inspectors accountable

Holding inspectorates, and inspectors, accountable helps improve efficiency and deter abuse. Most important is to hold inspectorates accountable for improvements in outcomes, such as reductions in workplace accidents and fires.

To deter abuse in Latvia, each inspector is required to have a clear program of inspections and provide a written report for each one, describing what was inspected and what the findings were. In addition, inspectorates are required to publicize the rights and responsibilities of businesses being inspected, including their right to appeal. These changes have empowered businesses to fight corruption by improving their access to information about regulatory requirements and ensuring that they have effective recourse in case of problems. The business community reports that petty corruption is much less a problem than it was in the 1990s, and the country's score on Transparency International's Corruption Perception Index has improved significantly.¹

Latvia's government also improved the effectiveness of its inspection regime by training its inspectors in client orientation. Inspectors are encouraged to become "consultants" to businesses—advising them, for example, on how best to guard against workplace accidents—on the assumption that the businesses too want to avoid problems in the workplace.

Monitor progress

Monitoring outcomes—such as maritime accidents, emissions of pollutants, and the incidence of workplace fires—can help show whether a government's objectives are being met. For an inspectorate, monitoring can help assess the cost-effectiveness of its compliance strategy and measure the performance of inspectors. Business surveys can show how burdensome inspections are for businesses and how this changes with reforms.

Latvia has conducted biannual business surveys since 2001 to assess such outcomes as the frequency and duration of inspections, the business community's perception of the quality of inspections, and the incidence of both sanctions and bribes. Inspectorates are required to keep records on the number and location of all inspec-

tions as well as the results, and most are developing outcome-based performance measures.

Conclusion

Reforms of inspection regimes have relatively low budgetary costs and benefits that accrue relatively quickly. The costs of reform can be further reduced, and compliance increased, by simplifying the regulatory requirements on businesses. Many developing countries, especially low-income ones, impose unrealistic requirements given their level of development and their enforcement capacity. Moreover, burdensome inspections contribute to the decision of many small businesses to operate informally, allowing them to escape all standards—from relatively unimportant ones to those that are critical.

Major reforms naturally are likely to face resistance from entrenched interests, particularly from inspectors who do not want to lose their jobs (or opportunities to collect bribes) and from higher officials in inspectorates who do not want to lose their power. That makes it critical to get high-level political support from the outset, especially where coordination across ministries is required. Resistance sometimes also comes from entrenched businesses that have established relations with "their" inspectors and prefer to avoid competition from new entrants.

Nevertheless, resistance to inspections reform is usually limited. Much of it can be overcome by providing clear objectives and performance indicators, accountability, training, and a "living wage" for inspectors. These costs (both financial and political) are low compared with the benefits—lower costs for businesses and greater ability to compete in global markets.

Note

1. http://www.transparency.org/policy_research/surveys_indices/cpi/2005.

Reference

World Bank. 2005. *Doing Business in 2006: Creating Jobs*. Washington, D.C.

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Telephone:
001 202 458 7281
Fax:
001 202 522 3480
Email:
ssmith7@worldbank.org

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