

Certification vs. Self-Regulation: Why Self-Regulation is Unlikely to Win

Andreas Ortmann, Ph.D.

*Center for Economic Research and Graduate Education,
Charles University
Economics Institute,
Academy of Sciences of the Czech Republic
Prague, Czech Republic*

andreas.ortmann@cerge-ei.cz, aortmann@yahoo.com

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A puzzling observation

- Success of ICFO members in “old Europe”
 - for all their diversity in organizational solutions, investigative practices, pricing strategies, ways of financing, a stable (and slowly expanding) set of certification, or monitoring organizations (COs)
(Guet 2002; Wilke 2005; Ortmann & Svitkova 2007; ICFO booklet on the occasion of the 50th anniversary)
 - no self-regulatory competitors to speak of
 - whatever meager attempts at self-regulation there were, failed
(to the best of my knowledge)
- Failure of COs to emerge in “new Europe” (no ICFO member from there)
 - what has emerged are self-regulatory organizations (SROs) of sorts (Ortmann & Svitkova in Gugerty & Prakash *forthcoming*)
 - Czech Donors’ Forum (CDF) as poster child
 - CDF business model now being “exported” to other countries

Aside: The CDF

- formally, a self-regulatory association of
 - foundations, foundation funds, donor companies
 - divided into membership divisions
 - representatives select the CDF Executive Board (for three years)
 - Annual Assembly of all members of the three active divisions is, formally, the managing body of the Czech Donors Forum
 - Executive Director is, formally, appointed by the Executive Board
 - employs 14 people (founded in 1997), more than certification agencies in other countries (see Ortmann & Svitkova 2007).
- formally, a civic association (state-mandated reporting requirements for civic associations being *de minimum*)
- membership requires
 - compliance with applicable laws and regulations
 - compliance with principles of ethical conduct issued by CDF
 - regular contributions/donations
 - a fee to be paid to Donors Forum

Aside: The CDF, continued

- formal structure likely to be different from the informal one (the CDF being located in a transition economy, no surprise there; recall that even now the countries of “new Europe” are at best located in the midfield of Transparency’s CPI rankings)
 - formal structure of the CDF bottom-up
 - informal structure top-down
 - historically CDF an artificial organization that over the years adopted a formal structure that suggests self-regulation, and club-like organization (compare IS, NACC)

Aside: The CDF, continued

- CDF has additional objectives (akin to “trade org”, “field-building org”)
 - lobbying group for its members
 - works hard to influence the fiscal policies of the government in ways favorable to its members (e.g., 1% tax designation, etc.)
 - has worked hard on becoming “a development agency for philanthropy”
 - introducing public rankings of top charitable organizations
 - persuading newspapers to report on these rankings
 - giving awards to journalists that spread the message
 - persuading corporations that making corporate funding of charitable activities part of company’s general business strategy is actually a smart idea
 - inventing “Donors message system”
 - key mediator of donations
 - umbrella organization/representative of the Czech nonprofit sector
 - sculptor of the Czech nonprofit sector: “We are the ones who create giving trends.” (Kalousová 2008)

Aside: The CDF, continued

- “exporter” of its business model to other CEE countries (financed generously by the Mott Foundation)
- “developer” on the European level
 - Worldwide Initiative for Grantmaker Support, WINGS
 - European Foundation Centre, EFC
- not exactly a poster child for accountability and transparency
 - latest annual report on website the one for 2005
 - no template for a good report:
 - e.g., no breakdown of sources is given
 - e.g., no salaries for the top administrators
 - has no clear-cut enforcement and/or monitoring mechanism that would guarantee that its members spent the raised funds in ways that could be considered efficient and wise (the *raison d’etre* of monitoring agencies)

(Another) Aside: The Czech Republic

- Lack of enforcement and/or monitoring mechanism problematic *per se* ... even more problematic given the situation in the CR (Pospisil 2006)
 - “Czech civil society sector remains a *terra incognita* in 2005”
 - “80,000 - 110,000 civil society organizations, depending on the definition used. And yet there are no reliable empirical data about them, there has been no systematic research, and debates about civil society, be they academic or public policy, lack both substance and quality as a result.”
 - Only about one third of the foundations and foundation filed their annual reports in 2002
 - only about 15% of those reports contained what they were required to contain
 - almost 40% contained no hard facts whatsoever
 - although the foundation law requires it, “Czech foundations and funds are typically not grant-makers”: about two thirds of these foundation-like organizations are not independent institutions but were “established by, and/or affiliated to, other institutions. Their main function is to fulfill the role of fund-raising and supporting agencies to their ‘parent’ institutions.”

(Another) Aside: The Czech Republic, ctd

- Lack of enforcement and/or monitoring mechanism problematic *per se* ... even more problematic given the situation in the CR (Pospisil 2006)
 - The registers do not penalize the offenders
 - There is a general low level of respect for law in the society, and NPOs are obviously no exception to the rule.
 - Equally poor is law enforcement. ...
- So why does everyone in transition economies oppose COs?
 - If you believe in the self-interest postulate of economic theory (as I, by and far, do), then this state of affairs suggest inferences that are not pleasant
 - Indeed, Donors Forums (and in particularly the CDF) quite comfortable with the lack of transparency and lack of accountability that they practice

(Another) Aside: The Czech Republic, ctd

- Trustworthiness requires accountable and transparent behavior (governance): tell the public/the donors how much money you got and what you did with it (through financial audits, annual reports, etc.)
- Trustworthiness gets eroded through self-dealings, misrepresentations in fundraising solicitations, other forms of using funds for other purposes (cross-subsidization), and similar violations of accountability and transparency. Now classic example: Red Cross Liberty (9/11) fund,
- Problem with the current state of affairs in “new Europe”: the equivalent of the UNICEF crisis in Germany, or the Red Cross “scandal”, or the United Way scandals, or the Oral Roberts U. debacle, etc. in the USA (see Ortmann 1996; Ortmann & Schlesinger 2003; see also see Gibelman & Gelman 2004) are waiting to happen and are likely to bring about attempts by the states to regulate charitable activities (see Grassley committee in the USA; recall Diana Aviv’s talk but recall also the Filer Commission etc.)

So why is self-regulation unlikely to be able to avoid these developments?

- Here is what theory says (and nothing is as practical as good theory!):
 - Shaked & Sutton (1981)
 - a self-regulatory profession has incentive to increase its income by restricting entry
 - Maxwell, Lyon, & Hackett (2000), Stefanides (2003), and DeMarzo, Fishman & Hagerty (2005)
 - self-regulation is attempt to undermine a perceived need for regulation (so almost by definition it can never accomplish as much as certification which is characterized by voluntary compliance with tougher standards than required by – factually existing or anticipated – regulation !)

So why is self-regulation unlikely to be able to avoid these developments? ctd

- Nunez (2001, 2007)
 - moves the hidden action problem squarely back onto center stage
 - analyzes the incentives of self-regulatory organizations to monitor its members and reveal (imperfectly) observed fraud
 - dynamic game of incomplete information
 - with possibility of self-regulatory organizations being bribed by members who have been identified as cheaters
- corruption-free benchmark:
 - there is always an equilibrium in which self-regulatory organizations do not invest in monitoring and do not reveal fraud
 - other equilibria exists but scant incentives to monitor quality and expose fraud for self-regulated industries. While there are situations where vigilance, fraud deterrence and fraud exposure might occur, it is not clear how likely these situations are.
- corruption scenario:
 - same problem. Nunez concludes that “a significant amount of fraud may in practice go undetected or may be concealed in self-regulated activities.” (Nunez 2007, 229)
- calibration? basic behavioral assumptions?
(self-interest and profit-maximization?)

So why is self-regulation unlikely to be able to avoid these developments? ctd

- Kleiner (2006)
 - provides empirical evidence that the effect of self-regulation on quality may be weak or even non-existent in certain professions when compared to certification

- Examples of failures of self-regulation:
- POB/Public Company Accounting Oversight Board
 - Congress concerned about consulting services that auditors can provide for their clients; Congress accepted self-regulation in form of public oversight board (POB reg power was broadened, funds tripled), Congress eventually installed nonetheless the PCAOP, POB then discontinued
- Accreditation in the USA:
 - The emergence of a for-profit education sector (Ortmann 2001; Ortmann 2007; Ortmann & Squire 2000) has led the ED to assert more rights (e.g., in accrediting accreditors)
- The SFC (“Grassley committee”) / IS panel and the reports leading to the Pension Protection Act of 2006
 - It took the aggression of the Grassley committee ...
 - And, I question whether the independent monitoring will succeed ...

Thank you !

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home.cerge-ei.cz/ortmann