<u>Creating Real Prosperity in Developing Markets</u>

A New and Sustainable Model for the 21st Century

By Shanker Singham & John R. Thomson

Summary.

Centuries of countless efforts to reduce poverty have made little progress, particularly in developing countries. Moreover., attempts to resolve long-festering political disputes peacefully have been unsuccessful in these countries. Both issues come together in tragically torn areas like the Palestinian territories, the Horn of Africa, Yemen, Kashmir and northern Sri Lanka, plus numerous other nations in Africa, Asia, the Caribbean and Latin America.

It is our belief, based on six decades' commercial and trade experience in developing countries, that a liberal, free-market economic development model can contribute significantly to political conflict resolution at the same time as it socially and economically enriches countless thousands of individuals in the world's poorest precincts.

We propose that operationally independent commercial and industrial trade zones, basically similar to Hong Kong, be established in select areas of the world. The concept of quasi-independent trade zones is, in fact, one of the few ways that the poorest countries can encourage the spectrum of business activity that creates meaningful economic growth. The Honduran government has taken initial steps to create such a model, an innovative move which can lift one of the western hemisphere's poorest countries to a position of economic well-being.

Background.

Over a third of the world's population lives on less than $2 per day. Reasons why developing countries remain impoverished include very weak governance, worse education and rampant corruption. The appalling humanitarian situation impacts not just the poor nations: developed countries feel the impact from unmanageably high rates of immigration that strain every aspect of their societies.

Good governance curtails corruption and improves education, delivering greater efficiency, eliminating waste and simultaneously creating wealth. Where the institutions are too weak to support meaningful reform and the government also pursues protectionist trade policies, inefficiency will increase and wealth will wither even further.

Trade liberalization, competitive markets and property rights protection accompanied by robust institutions to channel these political and economic forces, are powerful – and proven -- means for incentivizing business formation, employment and wealth creation. Clearly, it is critical to incentivize those in power to change governance models, together with reforming education and curbing corruption.

Investors and traders, the lifeblood of economic development, shy away from markets that do not guarantee certain fundamental economic rights -- an open and liberal trading system, competitive markets and protection of property. Despite frequent promises, they do not trust developing country governments to provide and enforce these safeguards. Without such trust, investment and development will not occur. International institutions, including the World Trade Organization, World Bank and International Monetary Fund have focused on this issue since their inception. Admirable progress achieved a 10 fold increase in global GDP between 1947 and 2001, as contrasted with a two fold increase between 1 AD and 1913, according to recent studies by Angus Maddison.[1] This progress has been achieved by removing obvious barriers, including punitive tariffs and restrictive border measures.

Barriers to trade and investment behind the border distort markets and are more pernicious, however. They have equivalent impact as tariffs but are much harder to identify and counter and are particularly difficult where governance is ineffective and/or corrupt.

Simply put, there is a failure of governance in many developing countries. This failure contributes to an economic climate where property rights are not protected, markets are not competitive and inefficiencies abound – all factors which drag on domestic economies and serve to deepen poverty and instability. Far from reform, anti-competitive restraints increase concentration of power and wealth in the hands of an elite, effectively exacerbating unemployment and low wages, and stimulating social unrest.

The elites proceed to use their power to control local media and politicians, often interchanging political positions with their own business interests. As this happens, frail national institutions become progressively vulnerable, with governance based on contacts rather than merit. Inefficiency reigns supreme and economic wealth drains from the economy, further damaging it and pushing even more people into poverty.

History demonstrates that the governance problem can rarely be solved from the inside, qualified exceptions including Brazil, Chile, China, South Korea and Vietnam aside. The purpose of this article is to discuss how the solution may evolve.

Historical Success and Failure.

For more than one thousand years, transnational entities have created and applied legal and regulatory systems different from the laws of the "nations" in which they operated. In order to suggest ways to address the governance problem outlined above, it is important to consider several transnational regulatory systems that have arisen out of necessity, or because a gap existed in national laws or customs.

Numerous transnational regulatory entities developed during the Middle Ages. Especially in Western Europe, following the Roman Empire's collapse, there were significant gaps in the laws and regulations of European states and proto-states. The environment for merchants, traders and property owners alike was weak, changeable and often capricious.

In the pre-Westphalian period[2] as trade started to increase, merchants became increasingly security conscious, fearing for their property and personal well-being. It thus became necessary for states interested in economic growth to develop unique regulatory strategies, while establishing broader systems on which merchants could rely.

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[1] Contours of the World Economy, 1 - 2030 AD, Angus Maddison (Oxford University Press, 2007). It should be pointed at that most of that two-fold increase occurred during the first period of globalization which began in the mid nineteenth century and ended at the start of the First World War.
[2] This period ended with the Treaty of Westphalia in 1648.

Hanseatic League and the Principle of Non-Interference.

Perhaps the best example of a transnational regulatory system in medieval times was the Hanseatic League, comprising some 200 towns in Northern Europe that banded together to promote their commercial interests, at home and abroad. Albeit powerful, the Hanseatic League was characterized by little formal organization and few institutions. Although the League was not a country, it made law, Hansa leaders negotiated with foreign governments directly, the diet (parliament) often sending delegations which effectively were embassies.

The League used its monopoly power to blockade countries that did not collaborate or cooperate. Clearly demonstrating the rights of a Westphalian nation state, the Hanseatic League went to war frequently during its four centuries' existence.[3]

While conventional wisdom pits the League against the developing nation state; many analysts contend the Hanseatic League was actually encouraged by rulers of many member states, effectively acknowledging their own weakness. The League was allowed – in fact, encouraged -- to be a countervailing power to the rulers, which enhanced its ability to commit to traders and investors frightened by the threat of states confiscating private wealth[4]. The nature of this so-called "commitment problem" was expressly recognized by Edward I of England in 1283: "Many merchants are put off from coming to this land with their merchandise, to the detriment of merchants and the whole kingdom."

The states and the League essentially made a compact, the states recognizing that without the League trade would be curtailed and economic growth stalled. Although the state clearly relinquished some power, it did so recognizing that in receiving a percentage of a more dynamic economic pie, they improved the state's ability to maintain power.

Groups like the Hanseatic League formed expressly to deal with the commitment problem. Merchants feared that, by dealing with a trading center, the power of the neighboring state's ruler could risk confiscation of their property. Medieval rulers' need to convince merchants this would not happen was answered by the merchant guilds (hansas), which could enforce agreements with rulers because they operated from outside and were trusted by the merchants.

This is precisely what developing countries currently face: investors and traders will not risk their property because they do not trust governmental structures. One solution is to bind those governments to international norms such as the WTO or Investment Treaties. However, that often does not provide sufficient confidence, as investors and traders question the WTO's ability to lock in reforms and provide a stable business environment behind the border. Investment treaties similarly have significant gaps in effectively enforcing agreements within the target country's borders.

Historically, attempts to solve the "commitment problem" did not work through bilateral and multilateral arrangements. This was because, where there is unequal bargaining power in a bilateral mechanism, the trader may simply choose to deal with another country, as the state benefiting from the bilateral is not important enough to the trader. Multilateral arrangements have often not worked because competing traders are unwilling to join together to discipline the offending region, and are willing to ignore the offending country or region altogether.

[3] The Hanseatic League is generally thought to have begun in the mid-twelfth century and ended at the end of the 16th century.

[4] Coordination, Commitment and Enforcement: The Case of the Merchant Guild, Greif, Milgrom and Weingast, Journal of Political Economy; August 1994, pp 745 et ff.

Multilateral arrangements in particular have not been successful in changing the behavior of weak or failing states. If such a state is in violation of WTO law, the only sanction is that the aggrieved state apply trade sanctions against it. The risk of trade sanctions for a small or failing state has been at best limited in its ability to force WTO-compliance.

The Hanseatic League was not the only example of a transnational regulatory system. Medieval guilds and military orders (among them the Knights Templar) were also examples of transnational frameworks enabling their participants to overcome the breakdown of trust between market participant and host country.

Applying Historical Lessons to Modern Problems.

In the 21st century, as the previously untrammeled power of the Westphalian states decline relative to new actors including NGOs and multi-national corporations, the lessons noted above suggest a way to ensure a regulatory framework that encourages foreign investment and trade, leading to economic development.

For some countries the path forward may be delegating regulatory authority for a particular region or enclave to a public or private institution that is separate from the country itself. A country's motivation for doing this is similar to the motivation of host countries not to interfere with the Hansa cities or medieval orders. That is, the host country recognizes it can not achieve its economic goals without providing this level of non-interference to an independent governing entity. Far from being a purely altruistic decision, it represents the realization that the government's fragile hold on power might cease, if investment and trade goals -- so vital to economic growth and social stability -- are not met. This is a reality playing out very graphically and dangerously in the Middle East.

The government of Honduras has recognized the value of such an enterprise. With Bolivia and Haiti one of the three least developed states in the western hemisphere, the government is preparing to establish a business friendly atmosphere for international traders and corporations through such a quasi-independent, free market city. The country is poised to become the first nation state in generations to make such a strong commitment to its economic growth and social development.

A primary reason developing countries remain poor, is lack of robust institutions. Government ministries, court systems and central banks are often simply unable to carry out the rule of law. Institutions cannot be transplanted from rich to poor countries like people or buildings: they acquire their strength from the regulatory frameworks they administer. If those frameworks maximize economic development, the institutions involved will clearly be more effective and therefore stronger.

The challenge is not merely to transport institutions or personnel from developed countries but to transpose regulatory structures that actually promote economic growth based on the rule of law. That countries have been unable to do this by themselves is obvious. While some advanced developing countries have made progress, such as Brazil moving towards welfare-enhancing economic and regulatory structures, all too many, indeed most, are headed in the wrong direction. This is often because vested-interest elites control weak political systems and benefit from inefficiency and distortion, making reform virtually impossible.

The relationship between China and Hong Kong today deserves careful analysis, as does the Hong Kong Basic Law which establishes its regulatory framework. When it took over Hong Kong from the British in 1997, the Chinese Communist Party recognized the tiny island's value, and more importantly understood the causes of its prosperity: free trade, market competition and property rights protection.

Given the Hong Kong Basic Law, the Beijing government understood its inability to control the Hong Kong market. Moreover, the Chinese government recognized that the mainland's socialist economic system, if applied to Hong Kong would curtail the city's continued growth and the economic benefits of controlling the colony. They expressly decided the "free trade policy" would continue to be applied, at least for fifty years from the handover.

Furthermore, the Chinese accepted the principle of non-interference with Hong Kong's economic and regulatory decisions. Recognizing the enclave's value as an economic engine of growth, China has kept a hands-off approach and Hong Kong has grown. Between 2004 and 2008 -- not a time noted for economic growth elsewhere – Hong Kong businesses enjoyed 46 billion U.S. dollars in increased revenues.[5] Tens of thousands of jobs have been created from that economic activity, for both Hong Kong and the Chinese mainland.

It is important to explore the reasons why transnational regulatory systems have declined and disappeared, in order to avoid a similar fate befalling our proposed economically independent free-city model. In the case of the Hanseatic League, one clue to its demise lay in its governing principles. The League, other medieval guilds, military orders and many early private regulatory networks eventually broke down because they were essentially anti-competitive cartels or monopolies.

Member cities monopolized and cartelized their export trade and were fundamentally mercantilist and protectionist. This eventually led to conflict and dissolution, because such policies inevitably harm economies by causing increased prices for products and services, lower worker wages and increased poverty. In fact, only a system that promotes competition creates a progressively growing, sustainable private network or national economy.

This ultimately leads to greater pressure on scarce resources and greater scope for conflict, precisely what happened with the Hanseatic League and, to some extent, the Knights Templar, the first transnational financial institution.[6] The delicate balance between national sovereignty and the principle of non-interference started to tip against the transnational organizations and their protection against being forcibly expropriated or extinguished was lost.

The Proposed Regulatory Framework.

Assuming transnational regulatory frameworks can deal with the governance challenge, the following governance framework for new free city entities is both practicable and sustainable. The advantage of such a system is that it allows reform to occur by interposing an entity impervious to the political forces that previously prevented reform, not by pushing at intractably reform-resistant domestic politics.

A host country (or two where we are dealing with a border region) would cede land in the form of a lease or concession to an entity that would administer the region in accordance with an agreed regulatory framework. The Regulatory Entity (REGENT) would be empowered to administer and implement all rules and regulations codified for its operation. It must be unmistakably clear to third parties dealing with this entity that the REGENT has the kind of power normally exercised by government, and for that to be believable and ongoing, the host government must cede much of its regulatory authority in exchange for

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[5] See, in general Hong Kong Annual Digest of Statistics (2004-2008 Edition) edited by Hong Kong Census and Statistics Department

[6] The Knights Templar frequently were bankers for both sides of a conflict and acquired great power as a result. Indeed at one point, Knights Templar controlled and ran the City of Sidon as a private entity. Their monopolistic power over finance led eventually to their demise at the hands of the other great power at the time, the Roman Catholic Church.

the economic benefits such entities can bring, through receipt of an agreed revenue stream or profit share dependent on the entity's success. Investors must be guaranteed the regulatory framework will be what the REGENT commits it to be, and sufficiently different from the host country's regulatory framework to be a significant investment, employment and profit boon to investors, the host country and, ultimately, its citizens. Indeed, the existence of an entity that is seen as successful because of this difference will lead to establishment of this regulatory environment to other parts of the host country, much as has happened in China.

Origins of the Regulatory Entity.

The REGENT could be a public-private partnership consisting of a private sector participant in partnership with – but independent from -- the host government, as well as other governments.

The motivation for a private sector participant to become involved with this entity would be the opportunity to participate and profit from inception in a project having the potential to generate wealth in a hitherto poor region. The REGENT could make its money in fees from concessionaires and investors that invest in development of the entity, from lease payments that are directly tied to increasing value of the land as the economic free-city grows and from fees for legitimate services, including airport, seaport, water and electricity. If potential investors perceive reasonable risk and commensurate profit potential by investing in a proposed REGENT, the entity would grow rapidly giving the REGENT, investors and the host government or governments mutually reinforcing rewards.

The REGENT would act as the controlling and enabling authority in the economic and commercial sphere. It would be supported by a professional staff selected for each individual's expertise.

It is important to stress that this model intends that the law translate pro-growth economic concepts, not impede them. International experts therefore have much to offer such regulatory bodies, and would provide a substantial part of the professional staff, for it is fundamental the REGENT ensure the regulatory environment is professionally -- not politically – conceived and implemented.

The caliber of individual technicians will significantly determine the quality, reliability and credibility of the regulatory systems, operating climate and ultimately the success of each free-city. This can be the crucial difference between an investor deciding to invest or not to invest.

The Sovereignty Question.

Critics may question whether such a system violates the sovereignty and constitutions of concerned countries, as there are wide-ranging implications for such an arrangement on the founding nation or nations. In order to preserve a balance between national sovereignty and letting investors and traders trust the REGENT, a small Joint Legislative Committee would be established with representatives of the host state[s] and the REGENT. The JLC, would operate with defined advise and consent powers.

The REGENT would have sole and exclusive regulatory authority, with its underlying statutes and regulations initially subject to JLC approval. However, to ensure the entity's governance is based on laws and not on arbitrary actions, the JLC would only be able to intervene consistent with the entity's Fundamental Principles, expressed below. The JLC would also be bound by the entity's Fundamental Principles, enabling market participants to predict clearly new regulatory developments. Investors and traders would thus be able to trust the regulatory framework, rather than an individual or collective governing authority.

The REGENT's Fundamental / Governing Laws.

As stated at the outset, the regulatory framework must be designed to maximize welfare and reduce inefficiency. The framework can realize these aims as follows.

1) The governing principles -- that is, Fundamental Laws -- are the constitutional parameters of the REGENT's regulatory authority. These principles must be defined in relationship to an economic philosophy as opposed to simply being the entity's free-wheeling authority, viz., a government of laws, not of men. Such a foundation is critical because it signals to an investor, indeed any market participant, that the REGENT's actions are defined and delimited by clear, quasi-constitutional parameters. The principles will act as a brake on potential abuses by the host nation, by the entity itself and by its participating traders and corporations. There are many examples of constitutional checks and balances, and we simply note here that the concept is clearly not new, and that many precedents exist to ensure sustainability.

2) Assuming these governing principles will check abuses of authority by the host government and REGENT, these principles should clearly accord with the fundamental purposes of the entire project and, as noted at the outset, can be characterized by trade liberalization, competitive markets and property rights protection.

Also as noted earlier, the primary reason earlier transnational regulatory frameworks failed is that their fundamental principles were protectionist, mercantilist and monopolistic. The fundamental purposes noted above are previous frameworks' polar opposites.

Potential Impact of the Administrative Entity.

To insure project longevity, any new system must recognize and reinforce maintenance of delicate balances between regulatory certainty and national sovereignty. Care must be taken that the regulatory framework established for each region or cities, that will not only enable preservation of the principle of non-interference but actually enhance it as the project becomes increasingly successful. As the REGENT becomes successful in attracting foreign investment and trade where the host country has failed, there will also be a propagation effect in other regions and countries.

Success breeds success. Thus, the regulatory framework will spread around the host country and region as the free-city and resulting prosperity grow, ultimately transforming developing countries far more quickly and sustainably than direct bilateral or multilateral negotiation. Just as the fundamental or governing purposes of the REGENT will largely determine the long-run sustainability of each free-city, competitive markets and the economic empowerment that follows will propel the entity into becoming an economic hub, magnetically attracting parts of the global supply chain.

It is important to understand that whereas disappearance of the Hanseatic League meant failure, disappearance of a REGENT as outlined here, means success. As benefits arise, they will stand in stark contrast to the surrounding area. This will create pressure to reduce the differences in the host country to zero, if it progressively adopts the REGENT's regulatory system. Thus, each REGENT ultimately acts like a powerful medication to cure the host country of diseases of bad governance and the poverty that flows from it.

Application to the World's Trouble Spots.

The world's most difficult conflict areas could benefit greatly by applying this concept. The fact that countries have to delegate aspects of regulatory control to a third party suggests a conflict resolution potential for the REGENT. Where the structure is based on two countries ceding concessions over contiguous land, it becomes particularly appropriate for such trouble-torn areas as Kashmir, the West Bank and Gaza, northern Sri Lanka and even cities whose "nationality" is disputed.

An approach that boldly focuses on business and economic solutions first, will not only radically improve personal and corporate welfare: it is far more likely to achieve the basic conditions for political conflict resolution, creating a climate for political dialogues far different from the current, typically unsuccessful practice of trying to resolve a political problem by attacking it head-on.

Today's Reality.

As we have noted, the "free cities" concept is far from new. Stanford economist, Paul Romer, has proposed Charter Cities, which would have governing laws administered by a REGENT-like entity that included other governments as well as private sector players. The key issue here would be to assign concessions at modest rents subject to an accelerator linked to the increasing value of the land. The Charter City would consist of a series of leaseholds, and sub-leases. Newt Gingrich has proposed the idea of Free Cities modeled along similar lines albeit with a somewhat greater private sector orientation.

In Saudi Arabia, the government is building a number of Economic Cities, which would be regulated not by the Saudi ministries, but by SAGIA, the Saudi office for the promotion of foreign investment. To be successful, it will be necessary to assure investors that the cities' regulatory environment cannot be interfered with, in ways detrimental to economic growth and wealth creation.

As referenced earlier, the Honduran Congress passed in January 2011 a constitutional amendment authorizing a charter city in the southern sector of the country. The Honduran model is to be based on Romer's Charter City, and it is highly significant that a constitutional amendment gives the new city the power to establish its own pro-economic growth regulatory framework.

Necessary Elements for Success.

To make progress, it is critical that the REGENT truly has autonomy that protects it from host government actions. Non-interference is precisely what will generate the host government's new-found wealth and the host must be convinced of this principle from the outset. This is what prevented the relevant national or equivalent powers from interfering with earlier transnational regulatory systems. The Hanseatic League did not last longer because its operating principles were based on protecting monopoly, as opposed to encouraging competitive markets, and this inevitably led to conflicts with other systems. Hong Kong enjoys its second century of steadily growing prosperity precisely because Great Britain and now China have guaranteed its economic, free-market independence.

As with most such systems, the underlying principle is trust. Investors and traders must believe in the non-interference guarantees, and in the Regulatory Entity. They must understand that the system's strength lies not in the REGENT's power but in the regulatory system itself and the Fundamental Laws ensuring liberal trade, competitive market (including tax) systems and property rights protection.

A careful system of dispute resolution where investors, REGENT and other shareholders have private rights of action versus the Host state (and to the extent applicable, the other entities and stakeholders) will ensure that market participants have the requisite confidence in the system.

Ultimately, nothing can prevent the most unlikely possibility of the Host ignoring its own best interests and rolling tanks into the free-city. Indeed, steps must be taken to ensure such a thoroughly improbable action would be the sole way the Host could interfere with the REGENT (and not by the creeping expropriations that so deeply concern investors and traders).

If such trust is established, the opportunity represented by this model of economic development can be life-changing for people trapped in badly governed countries, as well as contribute to the solving of long vexing political disputes the world over.

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