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The Promise of Enterprise Cities

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Article at a glance

- The process of globalization and increased rates of urbanization are forcing countries to rethink their approach to economic policy.
- Widespread reluctance to implement comprehensive reforms and burdensome legal and regulatory regimes are impediments to economic growth and entrepreneurship.
- Enterprise Cities, akin to free trade zones, are one possible solution to this problem. These are special jurisdictions with investor-friendly legal and regulatory policies that create the pre-conditions for entrepreneurship and stimulate competition-based growth.

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30 Years of Democratic & Economic Reform

Introduction

All around the world hundreds of millions, if not billions, of people are moving from the countryside to cities. In India alone, over the next 30 years, it is estimated that 500 million people will move, and anywhere between 200 and 500 new cities will need to be built. The infrastructure demand alone, some $57 trillion is far greater than governments by themselves can afford.[1] Somehow the private sector is going to have to be encouraged to fill the gap. Otherwise these new cities will be slums rather than environments of hope and opportunity.

At the same time, many groups are coming up with the idea of building new cities which are not only new physical constructions but whose soft infrastructure — governance and regulatory mechanisms — are also new. For decades, Free Trade Zones have existed around the world and have protected those who work in them from the corrosive effect of bad governance and distorting legal and regulatory systems in poorer countries. More recently, special economic zones in China have gone several steps beyond mere Free Trade Zones. In 1997 when Hong Kong reverted to Chinese rule, it did so as a Special Administrative Region (SAR). This allowed it to have its own legal and regulatory environment — so-called one country, two systems. In Dubai, financial regulation was essentially cleared to allow a completely new and advanced set of financial services regulations to be in place.

How Did We Get Here?

When the Berlin Wall fell, and the economies that had struggled under soviet control were freed to transition from command and control to market economies, we believed that the free market democratic system had triumphed over the communist/socialist one. We believed that the great historic struggle between state-led economies and free market ones was over, and would be only a museum piece for our children. In Latin America, in September 1992, the apertura took place, opening markets from decades of import substitution. The 1990s also saw China transition towards a market economy, and India drop decades of protectionism and socialist control. However, the overall story was a little more complicated.

In truth, the Washington Consensus of economic reform missed one vital ingredient — competitive markets inside the border. Conventional wisdom was that if borders were opened up, competition would automatically follow. But conventional wisdom was wrong because it neglected the impact of anti-competitive market distortions - government rules, regulations and practices that were hangovers from the days of import substitution or command and control economies (termed Anti-Competitive Market Distortions [ACMDs]).[2] The gatekeepers of the economy benefited from these and preserved or increased their anti-competitive, monopolistic power. Consumers did not see the benefits of competition, and reacted against the whole system of liberalization and globalization. Sometimes this was manifested in a very dramatic way, in Venezuela and Argentina for example, and sometimes in a less dramatic but equally pernicious way in increasing calls in developed countries to soften the rough edges of capitalism. The Washington Consensus fell into discredit, but for all the wrong reasons. Rather than fill in the missing plank of the Consensus by enacting laws, policies and developing international disciplines to promote competitive markets, countries began to dismantle the Consensus in its entirety, allowing elites and vested interest groups to warp the economic and regulatory system to their own ends. As always, it was the poor who suffered the most.

Even if states had the political will to drive competition through all their laws, rules and governance, now the problem is that this second generation of reforms (labor market flexibility, competitive regulatory systems in the newly privatized industries and so on) are much more difficult to push through because those who oppose that agenda were made much more powerful because of the lack of competition. The trade agenda in the WTO has stalled as countries adopt more and more mercantilist mindsets. Even getting meaningful disciplines on behind the border barriers have proved to be exceedingly difficult. The conventional tools seem to offer no way out of recession, stagnation and unemployment, and the radical promise of the 1990s seems to have fizzled.

The Trust Problem

Because of this network of behind the border barriers and ACMDs in emerging and developing markets, foreign investors and traders do not trust the investment and regulatory environment. They don't trust the governance structure. While it is certainly true that the state is too powerful in many developing/emerging markets — especially in those that emerged from the command and control of the former Soviet sphere—ironically, in many countries, the problem is not that the state is too strong but rather it is too weak to stand up against the forces of incumbents and elite groups who seek to change the regulatory environment to benefit their businesses, or to hang on to gains which have arisen as a result of a distorted market. This is particularly true in countries that had a private sector, but protected it through import substitution or other methods of protectionism. In these countries, the separation between the government acting on behalf of all the people, representing consumer welfare in the economic sense, and certain benefited elite groups is vanishingly small. Many of these dominant elites seek to perpetuate the network of ACMDs as their revenues depend on them. These rent seekers, who deprive consumers of the benefits of a consumer welfare enhancing market equilibrium overpower their governments as they control banking, media and other sectors. These potent economic forces block economic growth because for economic growth to occur, an open trading environment, competitive markets and strong protection of property rights (including intangible ones) is a vital pre-requisite. This is precisely why it is so difficult for governments in developing countries to engage in so-called second generation or regulatory reforms, even though the need for them is obvious, and the pathway to them is relatively clear.

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A Way Out

In this rapidly changing environment, scholars have also looked at alternate governance mechanisms — Paul Romer, in 2009, then at Stanford and now at the Stern Business School in New York coined the term charter cities.These are intended to be cities which were governed by a charter (rather like a charter school). Romer recognized the governance and regulatory problem and proposed a solution by applying a developed country's rules to the developing country's charter city. In an August, 2010 article in the National Review, Ken Hagerty and Newt Gingrich proposed the idea of free cities.[3] Libertarian groups wary of government have developed ideas of zones free of government influence of all kinds. Generally when multiple people have similar versions of the same idea, it is a good indication that the idea's time has arrived.

Some governments have also embraced some of these ideas. One good example is the Honduran government which has developed its own idea of model cities. The Honduran concept, known as ZEDEs (Zones of Economic Development and Employment) has been passed into law, both in the form of a Constitutional Amendment, and a Constitutional Statute. The Amendment passed almost unanimously — a great step for a provision that for some would seem to limit the government's sovereign power. The Supreme Court in Honduras had found the amendment and legislation to be unconstitutional, but the project was itself altered last year and rendered more likely to pass constitutional muster.

At Babson Global, we have established the Competitiveness and Enterprise Development

Project (CED Project) which is designed to promote the idea of Enterprise Cities – which are zones of regulatory autonomy in countries governed by a public-private partnership in the form of a Board. We seek to use these cities to create the pre-conditions of entrepreneurship, without which no amount of teaching will succeed. We see a conveyor belt of entrepreneurship starting with Enterprise Cities and ultimately leading to Centers of Entrepreneurial Leadership around the world teaching entrepreneurship to millions who now have the environment in which to take risk. Our first exposure to these ideas was in 2008 for a proposed city in the Middle East. We have also been privileged to work with a forward looking Honduran government on its proposals, and have discussed the potential benefits to Honduras of such a program with members of the Honduran Congress and civil society.

We are now negotiating with a number of governments for these Enterprise Cities, which will truly be communities of the future. Governments in emerging markets are interested in this idea, partly because they know that reform is necessary, and they have also faced the power of the vested interest groups who oppose competition and reform. They see Enterprise Cities as a way of having a zone with the kind of governance and economic/regulatory system that will stimulate competition-based growth that might act as a demonstration model to show their people what non-zero sum growth actually looks like. Naturally they are interested in the revenue stream from the profit share, but more than that, they are interested in the wider economic benefits and potential increase in investment and employment effects throughout the country. These governments know what a number of foreign investors and global capital facing companies have learned painfully over the last two decades — that reform is hard, and has been made more difficult because the first generation reforms of the 1990s did such a woefully bad job of promoting competitive markets inside borders. Those who were direct beneficiaries of the ACMDs we refer to above have become so powerful that they are able to stall the second generation reforms that are so needed in these countries. Couple this with general bureaucratic inertia, and generalized resistance to change, and real reform which goes beyond window dressing is all but impossible. Real reform must yield results.

Solving the Trust Problem

For these projects to be successful, investors need to be sure of two things: first, that the regulatory environment is indeed the best possible, maximizing trade openness, and property rights protection (including intangible property rights) with competitive markets inside the border delivering competition on the merits as the organizing economic principle. Second, investors, traders and other participants in these Cities of the Future must be assured that the host government will not intervene in ways that damage property rights, competitive markets and open trade. The PRC government had the same thing to prove just before the hand-over of Hong Kong in 1997. They did this very successfully by creating the Basic Law of Hong Kong which enshrined the principle of non-interference. At the time, some investors doubted whether the PRC would really leave Hong Kong alone, and withdrew or minimized their exposure. But the vast majority did not, and the signal to the foreign investment community that the Basic Law represented worked wonderfully well, allowing Hong Kong not only to survive but to thrive.[4]

These two objectives can be achieved by governments and developers who join together in a public private partnership to create these cities. They must agree on a Regulatory Framework Agreement that will set out the regulatory system, and the process of continuing regulation and law making. We envisage the governance aspects of this process taking the form of a Joint Development Board consisting of representation from both government and the developer. The board will delegate management to a city administrator and establish a system of dispute resolution so that foreign investors (and also domestic ones) trust the governance, legal and regulatory environment.

The benefit to the developer group is that this type of environment will match the pent up demand for good regulatory environments from companies that have large amounts of cash on balance sheets but are not certain of where they can successfully deploy it. The result will be zones where the land value will rapidly increase and the developer can capture that land value increase in a number of ways. We also envisage a profit share with the host government so that there are both carrots and sticks to align the incentives of the host government. Residents will be incentivized through the job creation that takes place in the zone and will eventually form a Residents' Council.

Such a concept is not without precedent. Hong Kong, Dubai and other modern cities are examples of this type of approach, but the reality is that the city state has been the predominant way that human societies have structured themselves, and the powerful nation state a relatively new innovation.

Such a concept is now being talked about in countries as diverse as Serbia, Honduras, and Morocco.

In order to launch such a project, there are certain pre-requisites. First, you need a developer who is committed and has an emotional connection to the country. Second, the developer must have land that can be used for the project. Unfortunately, in many countries this represents a near insurmountable obstacle, as use of eminent domain means a project designed to free people from government distortions is born in a kind of original sin of a government taking. Third, you need a government that recognizes the benefits to its reform agenda and to its own economic plan of such a designation of regulatory autonomy and is willing to confront its own challenges by thinking outside the box. Finally, you would need a good external infrastructure connecting the proposed Enterprise City with the rest of the country. There are countries which satisfy one or two of these pre-requisites, but few that satisfy all of them.

These cities will also generate the pre-conditions necessary to stimulate something which countries around the world are recognizing is vital to their economic development — entrepreneurship. Entrepreneurial companies in their early (3-5 years out) growth phase are massive economic engines, generating employment opportunities for the country. They also tend to be very innovative companies, satisfying another stated goal of countries around the world. It is easy to talk about stimulating entrepreneurship, and the data suggests that governments that develop funds to stimulate entrepreneurship simply generate a lot of start-ups, many of which fail in the same year they are created. This does no good for a national economy. However, to generate entrepreneurship, governments need to pay attention to the regulatory framework. They need to ensure that the business environment is not, as it often is in emerging markets, skewed in favor of the incumbent companies, and tilted against insurgents. By promoting competition on the merits as an organizing economic principle, the right conditions for a level playing field will be achieved.

It is clear that the idea of an Enterprise City is coming. All a country needs is a visionary administration and group of lawmakers. The liberated private sector will do the rest, transforming countries which struggle with poverty and desperation into havens of hope and opportunity. Like globalization, whether you like them or not, there is an inexorable economic logic to enterprise cities that will not long be resisted. Somewhere, somehow their time has come.♦

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Endnotes

[1] "India's Urban Awakening." Mckinsey Global Institute. McKinsey and Company, Apr. 2010. Web. 10 Mar. 2014. <https://www.mckinsey.com/~/media/McKinsey/dotcom/Insights%20and%20pubs/MGI/Research/Urbanization/Indias%20urban%20awakening%20Building%20inclusive%20cities/MGI_Indias_urban_awakening_executive_summary.ashx>.

[2] See generally Shanker A. Singham, Council on Foreign Relations Working Paper, October, 2012, Freeing the Global Market; See Alden F. Abbott and Singham, Enhancing Welfare by Attacking Anticompetitive Market Distortions, Concurrences

8 (2011); Singham, A General Theory of Trade and Competition; Trade Liberalization and Competitive Markets (CMP Publishing, 2007).

[3] Gingrich, Newt, and Ken Hagerty. "Free Cities | National Review Online." National Review Online. N.p., Aug. 2010. Web. 12 Mar. 2014. <http://www.nationalreview.com/articles/244140/free-cities-newt-gingrich-ken-hagerty>.

[4] "Basic Law - Index." Basic Law - Index. Web. 12 Mar. 2014. <http://www.basiclaw.gov.hk/en/index/index.html>.

As the Managing Director of the Competitiveness and Enterprise Development Project at Babson Global, Shanker A. Singham brings with him a wealth of experience in trade, competition and regulatory systems. He is one of the most experienced, and well known international trade and competition lawyers in the world, having authored the leading text book on the subject of trade, competition and regulatory frameworks. He has lectured, written and spoken extensively, including over one hundred articles and book chapters. He has led the market access practices of two prominent law firms most recently a top ten global law firm, Squire Sanders and he has represented multinational companies and governments. He is a cleared advisor to the United States Trade Representative and Department of Commerce, and is a Non-Government Advisor to the International Competition Network. He has also been a senior trade and economics advisor to a number of political candidates including Democratic Governors Lawton Chiles and Buddy McKay of Florida as well as Governor Mitt Romney's Presidential campaigns in 2008 and 2012. He is currently hosting a speaker series on the Moral Case for Liberalized Trade, Competition on the Merits and property Rights protection.

Shanker has his Masters and Undergraduate degrees in Chemistry from the University of Oxford, and postgraduate legal degrees in both the UK and US, having spent his early career working on the privatizations and development of competition laws in the former Soviet Union and Central and Eastern Europe with a prominent City of London law firm, and then in Latin America working on the apertura. Shanker is a life member of the Council on Foreign Relations and founded the Roundtable in 1997 as a way of promoting the notion of free trade, competitive markets and property rights protection around the world, having learned the lessons of the openings in the former Soviet sphere, Latin America and China and India's re-insertion into the global economy.

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