



**FREE
MARKET
ZONES**

**Deregulating
Canadian
Enterprise**

Herbert Grubel
THE FRASER INSTITUTE

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Preface

The U.S. is doing it. So is Great Britain. As a matter of fact, more than 80 nations have now set up free enterprise zones, free trade zones, export processing zones, free ports, and other variations on this theme. Free economic activity zones are small geographically defined areas within which lower taxes prevail, fewer commercial restrictions are in effect, and less government intervention into the economy takes place.

In an effort to create jobs, production and new business, the U.S. has created numerous such zones, which have met with great success. In the three years of operation of the Miami zone, for example, the value of goods passing through has tripled from \$170 million to \$500 million. Fourteen states have passed enterprise zone-related laws and numerous bills are now pending before both houses of Congress for the creation of yet additional ones.

Also, as can be expected, Great Britain under Margaret Thatcher has already started 13 zones in 11 communities, with another 11 to be set up in early 1983. And the entire city of Hong Kong, all 400 square miles of it, can for all intents and purposes be considered one gigantic free enterprise zone. (Although here the prognostication for the future is poor, with China scheduled to take over this booming metropolis in 1997).

But this limited-basis experiment with the capitalist system has attracted several unlikely candidates as well. The Peoples Republic of China has established four free trade zones along its southeastern coast. The largest of these, in Shenzhen, has shown remarkable success in its short three year history, registering a five-fold increase in annual revenue to \$100 million (U.S.), and a quintupling of its population to 160,000. As well, it has registered a staggering \$1.4 billion in foreign investment.

And India, hardly a bastion of laissez-faire capitalism, has also set up several zones. In an effort to promote business, it has established a five year holiday on taxes in its

enterprise zones, and has designated over 90 “zero industry” districts, where enforcement of India’s Monopolies and Restrictive Trades Practices Act will be reduced. In addition, a task force on foreign trade recently issued to India’s Ministry of Commerce urged the creation of additional zones in existing seaports which have adequate transport facilities and infrastructure.

What of Canada?

Unfortunately, our federal government remains unalterably opposed to the establishment of free economic zones in this country. Our Senate Committee investigating Canada-U.S. relations has been highly critical of duty-free manufacturing zones in the U.S., and this attitude permeates the thinking of our mandarins in Ottawa.

This is why *Free Market Zones: Deregulating Canadian Enterprise* written by Simon Fraser University Professor Herbert Grubel is of such great significance. Unlike some countries in the world, ours is a democracy. Our leaders, although at present opposed to the concept of free economic zones, may thus be led to change their minds, if the citizenry comes to support the idea. It is in the belief that the Canadian electorate is open to new ideas, and that our government, composed of reasonable men and women, will respond to rational argument, that The Fraser Institute is publishing this study of free market zones.

This book is of crucial importance because Professor Grubel’s research indicates that free economic zones would help to re-establish growth and development in communities hardest hit by the current recession, and provide a launching pad for future prosperity. In easy to understand non-technical language, Grubel shows how the zone concept can help Canada back onto the path of economic health. As well, free economic zones can benefit the poorest people in society. In the U.S., many zones are specifically slotted for depressed areas such as the South Bronx in New York City. If adopted in Canada, this country would pick up an invaluable weapon in its fight against poverty. It too would be able to harness the strength and power of the marketplace to the aid of the poor—in a way that merely “throwing money at the problem” can never accomplish.

The Fraser Institute has a deep and abiding interest in improving the performance of the economy, and especially in relieving the plight of the poor. It is therefore pleased to make public the research of Professor Herbert Grubel concerning the operation of free economic zones. However, owing to the independence of the author, the views he expresses may or may not conform singly or collectively with those of the members of The Fraser Institute.

January, 1983

Walter Block

Summary and Acknowledgements

In this study I have analyzed the economic and social implications of three important recent developments: the increased public awareness of the hidden costs of government regulation of economic activities, the strengthening of opposition to deregulation by powerful vested interest groups and the rapid expansion in many countries of the world of so-called free economic zones, where banking, insurance, international trade and enterprise are deregulated to varying degrees. One of the key analytical insights of this study is that the operation of free economic activity zones permits deregulation to be applied only to types of customers and industries that least require government protection. Because the bulk of regulation remains in the rest of the economy, opposition to the free activity zones from vested interests is minimal. Moreover, regulation aimed more precisely at those who need it the most is an economically and socially superior policy to one which is based on uniformity of treatment.

Because free economic activity zones have great economic and social merit and political acceptance, they have grown rapidly in many industrial and developing countries but not in Canada. The present study analyzes how Canada loses from these developments abroad and recommends the establishment of free economic activity zones here.

This study is the substantial revision of a draft that was circulated early in 1980 and which prompted several people to give me valuable comments and to send me relevant articles from newspapers and magazines. For this help my thanks go to Judith Bezeredi, Walter Block, Sid Fancy, Gerald Hobbs, Pat McGeer, Sally Pipes, Grant Reuber, Zane Spindler, Mike Walker and Ingo Walter.

Summary and Acknowledgements

In the Fall of 1981 I gave seminars on free economic zones at the Universities of Mannheim, Zurich and St. Gallen, at the German Military Academy in Hamburg, UNIDO in Vienna, the Institute for Weltwirtschaft in Kiel, the HWWA Institute in Hamburg and the Institute for International Economic Studies in Stockholm. As a result, I acquired new information and analytical insights, which resulted in a further revision of this study in February 1982. A scholarly analysis of the theory of free economic zones has been published in *Weltwirtschaftliches Archiv*, 1, 1982.

There are no footnotes in this study. Direct quotations are attributed in the text. The sources of main ideas and suggestions for further readings are given in notes to individual chapters found at the end of the last chapter. Relevant literature is listed at the end of the study. Because of the lack of scholarly work on free enterprise zones, this study has drawn on information contained in newspapers, magazines and pamphlets. This fact is apparent from the literature survey and suggests that the ideas and facts presented are new and tentative, but also exciting and evolving rapidly.

It remains for me to thank my secretary, Donna Popovic for her reliable work on the typewriter and the new Word Processor. Thanks also go to Larry Boland who provided invaluable assistance in getting the Processor to work.

January, 1983

H.G. Grubel

About the Author



HERBERT GRUBEL

Since 1972, Herbert Grubel has been a Professor at Simon Fraser University in the Department of Economics and Commerce specializing in international trade and finance. In addition, he is presently Director of the Centre for Economic Research. He has held academic posts at Stanford University, the University of Chicago and the University of Pennsylvania and in 1978-79 was CIDA Visiting Professor at the University of Nairobi, Kenya. In 1974-75 Professor Grubel was a visiting Research Fellow at Nuffield College, Oxford and during 1970-71 he was a Senior Policy Analyst for the U.S. Treasury Department in Washington, D.C.

Born in Germany in 1934, Professor Grubel was educated at Rutgers University and at Yale where he received his Ph.D. in Economics in 1962. His latest books are *Intra-Industry Trade* (Macmillan, 1976); *International Economics* (Irwin-Dorsey, 1977); *Brain Drain: Determinants, Measurement and Welfare Effects* (Wilfrid Laurier University Press, 1977); and *The Real Cost of the B.C. Milk Board* (The Fraser Institute, 1977). Professor Grubel has been the recipient of research grants from both the National Science Foundation and the Canada Council and is listed in "Who's Who in Canada." He is a member of the Fraser Institute's Editorial Advisory Board.

CHAPTER 1

INTRODUCTION

In this study I propose that the federal and provincial governments in Canada permit or actively encourage the establishment of free economic zones through the selective reduction or elimination of regulations, controls, and taxes. The following types of activity zones should be established through the setting aside of geographically defined areas of operation:

1. Free trade zones, where firms can import free of duty goods for assembly, processing and distribution for either export or sale in Canada;
2. Free retail zones, where foreign tourists can purchase goods free from customs and excise taxes;
3. Free enterprise zones, where closed shops and other restrictive practices of unions are prohibited, contributions by employers and workers to the unemployment insurance and Canada pension plan programs are voluntary, minimum wage legislation is inapplicable, other regulations and controls are minimal and there are no local taxes, with all services needed in the zone paid for by users;
4. Free medical zones, where doctors and drug companies can make available drugs, surgical procedures and therapies even if they have not been approved by governmental or professional regulatory authorities of Canada;
5. Free gambling zones, where all forms of gambling are permitted without restrictions;
6. Free investment zones, where securities and other assets can be sold unrestricted by the existing government regulations governing such sales;

In addition, governments should free the following activities selectively through the elimination of controls and

taxes on specific types of business or customers. Examples in this category are:

1. Banking, where banks can carry out business denominated in foreign currencies without the requirement to maintain minimum reserves and pay certain taxes levied on regular banking;
2. Insurance, where companies can underwrite hazards normally afflicting customers that do not require paternalistic protection by the government.

Expected Benefits

The proposed establishment of free economic zones can be expected to have the following benefits for society:

1. The economic activities freed from the costly burdens of regulation, control, and taxation will expand rapidly as they become competitive in world markets and in Canada. There will be favourable employment, productivity, and balance of payments implications from such expansion.
2. The rate of innovation of products, technology and services in the free activity zones will be raised by the absence of controls and regulatory burdens, which will lead to increased sales and productivity of capital and labour.
3. All members of society enjoy the benefits of decreased paternalism. Consumers can choose more freely products and services; workers can elect to trade off, the benefits of higher wages and occupational mobility for the absence of public retirement plans, unemployment benefits and the right to strike; wealthholders and entrepreneurs can place their capital and talents in potentially high-profit ventures in return for additional risks they consider worth taking.
4. Free economic zones represent a form of **partial** deregulation that permits society to maintain regulation and control for the broad, general public and specific industries and consumers, while the benefits from free competition and unrestrained freedom of choice accrue to those not needing government protection. Producers,

consumers and workers with a vested interest in existing regulation continue to enjoy most of the benefits derived from it and will not very actively oppose the creation of the free economic zones. The beneficiaries of the deregulation will give their political support to the free economic zones.

5. The success of free economic zones in terms of greater efficiency and dynamic growth may be considered to be an economic indicator that measures the costs associated with government regulation and control. The economic performance of free zones therefore can serve as a useful guide to the determination of the socially optimal degree of regulation and controls.

Expected Costs

The major costs of free economic activity zones consist of two parts:

1. To a certain extent activities in the zones do not create new but only divert business away from regulated and taxed areas within Canada. Such diversion can lead to locationally determined inefficiencies and to the loss of tax revenue. However, these costs are mitigated by the diversion of trade away from other countries and towards Canada. In fact, as will be shown below, the establishment of such Canadian zones may be required in the near future simply as a defensive measure to prevent excessive diversion of trade to such zones in other countries.
2. The free economic zone activities lead to the appearance of economic and social costs that regulation and control were designed originally to reduce or eliminate. For example, costs occur in the form of lower protection for import competing industries. Standards of morality are lowered as a result of more gambling. There will be more deaths from medical treatment and more unemployed workers without insurance benefits. The magnitude of these costs of deregulation cannot be measured readily since they are based largely on personal tastes and preferences and, most important, on individuals' views of governments' responsibility in regulating peoples' lives for their own good and that of society as a whole.

Need for Benefit-Cost Analysis

Whatever may be the costs of partial deregulation through free activity zones, the main point of the detailed analysis in the next chapters is that they must be compared not with a situation in which regulation works perfectly and creates no costs of its own. Instead, the comparison must be with real world conditions in which regulation is accompanied by great costs, the elimination of which represents the benefits of free activity zones noted above.

In Chapter 2, I review economists' recent writings on the benefits and costs of regulation. This literature has concluded broadly that the nature of the regulatory process and the incentive structure determining the behaviour of politicians, regulatory agencies, the regulated industries and their customers are strongly biased towards over-regulation. As a result the economic and social costs of regulation tend to be so great that in many instances they exceed the costs which unregulated markets would have produced. As a result of these conclusions, many economists have suggested the termination of existing regulations and at least fundamental revisions of operating procedures.

The analysis of Chapter 2 thus provides the intellectual foundation on which rests the case for the creation of free economic zones. In the broad context of arguments over the merits of regulation, the creation of free economic zones will be seen to be a complementary or substitute policy for outright deregulation or the improvement of procedures. Each of these alternatives faces heavy opposition and has some disadvantages of their own which do not apply to free economic zones.

Plan of Exposition

Chapter 3 contains an economic analysis of the welfare effects of free economic zones. The following chapters present detailed descriptions of purposes and costs of existing regulation and specific deregulation proposals for seven different types of zones: trade (Chapter 4), enterprise (Chapter 5), gambling (Chapter 6), medical and drug (Chapter 7), banking (Chapter 8), investment (Chapter 9), and insurance (Chapter 10). Where possible, I present data on zones estab-

lished in other countries and evaluate their success and failures.

The general philosophy underlying this study is neo-conservative. It is therefore not based on the ideological premise that free markets necessarily result in an efficient economy and an ideal society. Instead the study is based on the empirical judgement that regulation and the weakening of free market institutions, while producing some benefits, has often resulted in costs greater than those benefits. The proposed creation of free economic zones is part of a three-pronged attack on the problem of existing regulation, complementing in some instances and substituting in others for policies of complete deregulation or reform of the regulatory process.

CHAPTER 2

THE BENEFITS AND COSTS OF REGULATION

Free markets for goods, services, labour, and capital have served Canadians and the Western world extremely well. Through the invisible hand of competition free markets have created standards of living that are unprecedented in the history of mankind. At the same time they permitted a maximum of personal freedom and economic and social mobility within a political system of democracy. But the system of free markets is not perfect and never lacked critics pointing out its shortcomings. Most influential among these have been the romantic socialists, whose norm of an ideal society is one in which there is no competition and no uncertainty and in which each contributes according to ability and receives according to need.

Regulation in the mixed economy

The ideals of romantic socialism have a strong appeal. Most people were at one time or another emotionally attracted by the ideals of romantic socialism and thereby moved to some kind of intellectual or political action. Its ideals underly Marxism and its political manifestations in many parts of the world. In Canada and most of the industrialized countries of the West, it has led to the development of the ideal of a “mixed economy” which was designed to combine the best parts of the free market system and of romantic socialism. The methods available for the achievement of this mixed economy are policies of economic and social engineering in the form of government regulation, control, ownership, spending, and taxation.

Enthusiasm for this economic engineering grew rapidly after the second World War as a result of two important developments. On the one side, there was the economic catastrophe of the Great Depression in the 1930s, which was interpreted as a manifestation of a fundamental pathology of the free market system. On the other side, there were the obvious successes of economic planning in the United States and Germany during the second World War, which mobilized latent economic resources at a rate considered impossible before. At the same time, science increased man's understanding of the laws of nature, which in the hands of engineers led to vast improvements in technology and economic productivity. Knowledge in economics, strengthened through the use of mathematics, model-building and econometrics, rapidly became more and more like a science and discovered apparently universally valid laws of economics. Use of these laws for social engineering was the logical next step and was expected to permit the correction of all failures of the free market system.

The support for these economic engineering policies has come from a powerful alliance of interest groups. There were intellectuals in many professions who were driven by their moral sense of responsibility to improve man's economic and social environment. But self-interest also played an important role, as economists, bureaucrats, and politicians saw in economic engineering an opportunity to increase their incomes, power, and influence. In addition, the mixed economy was supported by interest groups that expected to gain by government programs which promised to provide free goods and services to shelter them from the economic insecurities of free markets.

The history of economic engineering just sketched is important in understanding the following analysis of the nature and shortcomings of regulation. It also helps to explain the difficulties encountered in efforts to reduce the amount of economic engineering in Canada. It is precisely these difficulties, which lead me to suggest the establishment of free economic zones.

The Benefits from Regulation

Traditionally, basic economic theory has shown very successfully that free markets often are subject to failure and do

not lead to a maximally efficient allocation of economic resources. One of the most studied forms of market failures occurs through monopolies. These are caused by the nature of technology, which allows the most efficient, low-cost production of services only through the exploitation of economies of scale by one of very few firms. Examples of such so-called natural monopolies involve the supply of electricity, water, telephones, mail services, railroads, airlines, buses, and trucking. The theory suggests that completely free markets would result in the establishment of monopoly firms that would exploit consumers and create economic waste through the failure to take full advantage of economies of scale in production.

There are several economic engineering responses to these market failures. One is to permit monopoly to exist and in fact assure its existence through protective laws. Usually, such monopoly firms are owned completely by the state. Examples of this solution are the Post-Office, Air Canada and the Canadian National Railways. A second response is to permit natural monopoly firms to be owned by private investors and to have appointed regulatory bodies to assure that price and output decisions are in the public interest. Examples of this solution are companies providing telephone, electricity, gas, bus, and trucking.

Externalities

A second form of market failure occurs in the form of externalities, which are defined as influences on the welfare of people that are unintended and uncompensated by-products of private production or consumption. A classical example of an externality is pollution of the environment produced by smoke from factories, causing people discomfort and the need for extra cleaning expenses. Governments deal with the problem of externalities of this type by legislation prohibiting the emission of pollution or mandating the installation of cleansing equipment. In principle, the social benefits of a clean environment are greater than the legislated costs of achieving it. The higher costs of production caused by the legislation result in higher product prices. But since these prices signal to consumers the true social cost of production, they generate conditions for efficient purchase

levels by consumers and output decisions by firms.

The concept of externalities in recent years has been used increasingly to justify product safety legislation also. Externalities arise when products cause accidental injuries or death of users, as for example in the use of automobiles or drugs. Victims require publicly financed medical care and their families often become burdens of the state welfare system. The market prices of dangerous products thus do not reflect the full social cost of producing and using them. Legislation requiring that certain standards of product safety be met reduces the frequency of accidents and therefore the social costs they cause. In principle, the social benefits from reduced accidents is greater than the legislated increase in costs of production.

A third class of market failure producing externalities is associated with private insurance in the field of unemployment, health, and pensions. Private insurance companies in these fields have high costs of administration because of the need to establish risk categories and charge actuarially sound premiums for each. In some categories of risk, private insurance premiums are so high that the people in them don't purchase insurance at all. Government involvement in the field of unemployment, health, automobile, and retirement insurance is justified on the grounds that it improves welfare in three ways.

First, governmental costs of administration are lowered because there are no sales costs nor expenses of determining risk classes. In recent years, computers have permitted the exploitation of scale economies in dealing with large numbers of people, which a fragmented private industry could not enjoy. Second, people in high risk classes who would not have been able to purchase private insurance receive the benefits of the public program. And third, because of the universal public insurance the state saves the costs of general welfare benefits that would have been required by people who otherwise would have been on general public assistance.

Economic instability

A final type of market failure resulting in externalities arises from economic instability. For example, the production of

milk shows seasonal fluctuations and costs of production are subject to random changes in the prices of animal feed and other inputs. As a result, producers' incomes and consumer prices are unstable and the producers' income instabilities result in higher average costs of production than would prevail with stable incomes. Nor are private efforts to reduce instabilities completely successful because maverick producers always can profit from the collective stabilization efforts of groups of farmers. Government response to this problem has been the creation and protection of producers' monopolies through marketing boards with mandatory membership for all farmers. The operation of these boards is supervised by government appointed individuals that are charged with assuring that prices for consumers and producers are stabilized and set at a level granting farmers a "fair" return. Economic welfare is increased through greater stability of consumer prices and producer incomes, and lower average consumer prices, which are brought about by production costs lowered through the reduced uncertainties.

Analogous arguments are made in the case of price instabilities for shoes and textiles in Canada, which are due to fluctuations in exchange rates and competition from abroad. Canadian producers of these goods are protected from these fluctuations and foreign competition through tariffs and quotas on imports. While these policies raise consumer prices, overall social welfare is increased because the workers in these industries do not require unemployment compensation, public retraining, and relocation programs. In addition, factory owners continue to pay taxes. In the longer run, profits in the industry permit the installation of modern equipment that lowers costs of production. Finally, therefore, consumer prices of textiles and shoes tend to be lower and more stable than they would have been if the industries had been without the protection.

The conventional wisdom

The preceding analysis of the nature of market failures and of remedial government controls and regulation constituted conventional wisdom of the post-war years in Canada and is still accepted as correct by many people even now. How-

ever, since at least the early 1970s regulation has been subject to sophisticated study, drawing on political science, psychology, and empirical evidence of the actual working of regulation. This recent study concluded that the preceding claims represent a “naive view of regulation” and that “non-market failures” severely limit or turn negative the net social benefits from many forms of regulation.

The Problem of Non-Market Failure

The actual record of government regulation and control in dealing with market failure is somewhat mixed. In most instances government policies have eliminated the problems raised by the existence of externalities as identified in the analysis above. In a few cases, the externalities have not been eliminated, though their cost levels may have been reduced. However, the main case against government regulation and control is not that they have failed badly in achieving the designated objectives of eliminating market failures. The main problem with these government policies is that they have resulted in side-effects and social costs many of which were not intended nor foreseen.

These costs are often referred to as non-market failures. They arose because economic policies have to be based on the perception of economic laws and relationships derived as generalizations from past observations. It is then necessary to assume that these relationships hold up when the government changes the environment which underlies the observations. Unlike the natural sciences, the validity of the economic laws could not be tested before application. In effect, the policies constitute experimentation in economics. The following analysis, therefore, in a sense represents a report on what went wrong with the economic engineering experiments designed to deal with market failures.

Monopoly regulation

The regulation of monopolies through public rate-setting by supervisory authorities has given rise to three types of non-market failures. First, the regulatory agencies tend to be staffed by people more sympathetic to the interests of the regulated industry stockholders, managers and workers, than the industry’s customers. This phenomenon is ex-

plained by the “capture theory” of monopoly regulation as being due to the incentive structure created by the regulatory process itself. Thus, each individual consumer benefits very little from regulations which serve consumer interests. At the same time, there are high costs of organizing large groups of consumers and of acquiring the technical and financial expertise to provide an effective lobby. Stockholders, managers and employees of the regulated industries, on the other hand, tend to benefit greatly from being able to influence the decision of the regulatory authorities in their favour. Being small in number, they can organize at relatively low cost and mobilize support for their goals. Also, technical expertise required by all regulatory bodies is available often only from the regulated industry itself. The information provided therefore tends to have a bias favouring the industry. The persons serving as members of the regulatory body tend to be past or prospective employees of the regulated industry. Not unexpectedly they are likely to see matters from the industry’s viewpoint either quite naturally or in expectation of rewards paid through lucrative employment after public service.

As a result of the capture of the regulatory authority decision-making body, there exists a tendency for policies to favour the regulated industries as in the setting of rates charged to consumers, the exclusion of competition, and the introduction of new technology. Consequently, the static and dynamic efficiency of regulated industries is less than optimum. Most consumers of telephone, post-office, railroads, and other utility-regulated industries have ample personal experience with this phenomenon. They are painfully aware of the difference in the quality of service provided by employees of these industries and those of unregulated business. Also they are likely to have observed such regulated business to engage in practices that would cause bankruptcies in industries exposed to full competition. Numerous economic studies have shown that episodal evidence of this is symptomatic of a general bias towards inefficiency. It has been found that, at the very best, in certain industries where regulated and non-regulated firms exist side by side and where there has been little technical change, as in the electric power industry and railroads,

efficiency is about the same and there are none of the lower costs that the naive theory had predicted to result from the regulated exploitation of economies of scale.

Alternatives foreclosed

Second, as a result of the government-created monopoly position of regulated industries, consumers often have none, or only very unsuitable alternatives. The development of substitutes is prevented by the laws protecting the regulated industry's monopoly. These conditions give extraordinary power to labour unions in regulated industries. When airlines, the post-office, railroads, buses, ferries, telephone, and electric supply companies are struck, the public has no alternatives and the cost is enormous. Therefore unions hold powers to obtain higher wages, concessions on feather bedding and labour-saving technological innovation that are not available in non-regulated industries. The economic costs of the policy-created union strength in these industries is reflected in higher operating expenses due to higher wages and slower rates of introduction of new technologies, products and services. In addition, the public is inconvenienced severely by the periodic strikes that afflict the regulated industries.

Third, the price and output decisions of regulated industries are politicized and made to serve other social objectives. For example, airlines are forced to provide flight service to small towns solely because of political influence not economic efficiency. Airlines do not oppose such money-losing service since the regulatory authority guarantees prices on other routes through what is known as cross-subsidization such that overall returns to capital are adequate. Labour providing the service in regulated and cross-subsidized industries is happy with the resultant employment opportunities. People located in the area serviced by the non-profitable flight believe that they benefit greatly and are happy with the authorities' decisions. The hapless customers who pay the price for the politization of the industry's output decisions through higher fares on other routes typically have no knowledge about the fact. Or even if they do, they cannot organize opposition effectively because of the difficulties noted above.

The preceding analysis of the incentive structure affecting important regulatory decisions of the airline industry obviously applies also to regulated trucking, ferries, and buses. It applies less obviously to regulated electricity, water and telephone companies and the post-office, which often are required to serve areas and customers at non-economic rates designed for the achievement of other social and political objectives.

Overestimating the cost of monopolies

We have just noted that the naive view of regulation has tended to overlook or underestimate the cost of regulation due to the biased incentive structure affecting decisions of regulatory authorities, the implicit granting of monopolies to labour unions and the politization of output and rate decisions. In addition, for three reasons it also grossly overestimated the cost of having unregulated monopolies. First, there are no important industrial products for which there are no substitutes available for consumers, actually or potentially. Energy for heat, lighting and power can be supplied by electricity, gas, coal, wind turbines, and wood. A monopolist's ability to raise prices is thus severely limited. If the price is too high, consumers simply obtain energy from other sources. Furthermore, at higher prices consumers are induced to install energy-saving devices such as insulation, heat pumps and solar heating systems, which reduce demand and limit, or even eliminate the monopolists' profits from higher prices. As a result of the high level of scientific and technological knowledge in the world today, monopolists' price-raising activities are curtailed even further by the threat of new products and technologies created as a result of the higher prices.

Second, it is incorrect that monopoly regulation is required to provide service to certain areas and customers that would otherwise be without it. Experience with airline deregulation in the United States showed that after major carriers abandoned previously mandated services, small commuter airlines were created. They used optimally sized equipment to service many small population centres with higher quality and greater frequency flights than those that existed before. Similar processes of adjustment would lead

to the supply of other forms of transportation and of utilities to customers if regulation ceased the mandated supply at non-profitable rates by the existing monopoly.

Third, even at times when substitutes for electricity and other natural monopolies were less available than they are in our more sophisticated technological age, market forces generated powerful curbs on the price-raising ability of firms. One of these consisted of the threat posed by an entrepreneur familiar with the size of an electric power company's excess profits. Such a person would approach customers with an offer to supply them with electricity at a price below that of the monopolist, but sufficiently high to make it feasible economically to replicate the existing production facilities. Once the entrepreneur had signed up most of the monopolist's customers at the lower price, he could go ahead and build more facilities. More likely, the monopolist would purchase from him the customer supply contracts in order to avoid the catastrophic losses from owning an idle plant. The very threat that such entrepreneurs would take advantage of the fact that the monopolist owns only the plant and lines but not the customers, represents an important curb on the price-raising ability of the monopolist.

In sum, the preceding analysis has argued that the naive view of the benefits and costs of natural monopoly regulation involves an overestimate of the economic and social cost of monopoly and a disregard or underestimate of the costs associated with the regulatory process itself. For the main point of this study it is important to note that the incentive structure of the regulatory process has resulted in the formation of a strong alliance of stockholders, managers, workers, bureaucrats in the regulatory agencies, and subsidized customers which opposes deregulation because of the loss of benefits it would bring.

The Control of Externalities

In the case of regulation designed to control the cost of externalities, it is useful to structure the discussion of non-market failures by considering in turn the four classes of externalities.

Pollution

Unintended costs of regulation designed to deal with this type of externality arise because legislation typically fails to specify operationally what constitutes an unpolluted environment and by what methods it is to be achieved. This feature of the legislation is probably unavoidable in practice because law-makers cannot know all present and likely future pollution control technology and costs. This fact makes it impossible to generate the benefit-cost calculations that should underlie rational social choices about the target levels of environmental quality and types of technology used.

Consequently bureaucrats charged with enforcing pollution control legislation have enormous discretionary power in choosing targets and methods. Canada would get the optimal levels and methods of pollution control if the bureaucrats with this power were under constant surveillance by politicians and kept in check by the judiciary. Unfortunately, however, this is not the case.

Biased incentive structure

The level of pollution control is likely to be too high in Canada because of a biased incentive structure affecting bureaucratic decisions. Those responsible for operational pollution control directives fear most the consequences of having mandated weak and low levels of control. For example, if pollution results in a mass kill of fish on a river, perhaps because of an unusual coincidence of simultaneously high levels of pollution emission by several factories, low levels of water and high temperatures, the individual bureaucrat charged with managing the controls on that river, the agency employing him, and the minister running the agency suffer great adverse publicity. They will be punished by the system through slowed career progress, reduced income, criticism in cabinet, and fewer votes in public elections. On the other hand, the costs of mandating excessive pollution control standards have a very diffuse incidence and often are not even known publicly. Those affected by the higher costs of products, the failure to get high-paying jobs because factories locate away from the river or in another country, have no incentives or informa-

tion to lobby against these costs. Because of this asymmetry in the cost of alternative actions, bureaucrats and politicians have a tendency to interpret ambiguous legislation or standards in the direction of mandating a cleaner environment than the public would desire, given its true costs. Decisions may occasionally coincide with what the public would have chosen, but the existing incentive structure makes it highly unlikely that there ever is less than optimal government expenditure on environmental quality and often, too much.

Aggrandizement

A second source of excess costs from regulation arises from the fact that bureaucrats' pay and power are greater the larger is the staff they head and the agency in which they work. This fact has resulted in the tendency of bureaucratic agencies to take on the very expensive and labour-intensive job of mandating precise technologies to be used for pollution control. This is so in spite of the fact that economists have almost unanimously agreed that the most efficient method is to specify desired levels or purity of polluting effluents and to allow polluters themselves to choose the methods by which these are to be achieved. Great economic costs tend to arise because the specification of control methods can never be tailored completely to fit the specific, often changing circumstances of every factory and the often quickly changing technology. In addition, the specification of methods rather than objectives raises the cost of running the bureaucratic agencies.

The preceding analysis does not imply that there is no limit to the excess costs bureaucrats and politicians are induced by the incentive structure to impose on the public. If costs become too great, it pays producers and consumers to organize and oppose the actions of the government. For instance, during the late 1970s in the United States political pressures led to a reduction in environmental standards for mining and coal-fired electricity generating plants. In the next section we discuss consumer and work place safety regulations, which generated several outstanding cases of political opposition because the same bureaucratic bias towards overregulation present there had led to severe regulatory excesses.

Product and workers safety

As in the case of pollution control legislation, the laws regulating safety and other characteristics of consumer products such as drugs and automobiles, and of work places leave much discretion in the setting of standards and the application of methods to the bureaucrats staffing the regulatory agencies. And again, the incentive structure underlying the actions of these bureaucrats and of their political and judicial guardians is biased in favour of too much and too detailed regulation.

Consider the case of drug regulation. Of overwhelming dominance is the regulators' desire to avoid the possibility of having permitted the sale of a drug that turns out to have unexpected adverse side-effects, such as happened with the drug Thalidomide during the 1960s, which resulted in massive birth defects. Any such unexpected side-effects of drugs lead to public trials and condemnation of the regulatory authorities. This has important adverse consequences for the personal careers and incomes of bureaucrats and politicians. Of course, it is impossible to eliminate or know all risks associated with the introduction of new drugs, but regulators can and do choose a certain level before releasing drugs for sale.

Unfortunately, the lowering of risks from new drugs results in costs in the form of higher drug prices and in the delay in the introduction of new drugs. It has been estimated that U.S. drug regulation requires companies to spend \$54 million on average testing new drugs. The average time required for this testing procedure was 34 months as of the late 1970s. The high cost of meeting regulatory requirements has resulted in the phenomenon of "orphan drugs." These are drugs that promise to be beneficial and are known to have limited risks after some testing or successful use abroad. But the U.S. market is so small that it does not pay to go through the full, required testing process to bring them to the point of regulatory approval and sale. Canada's more limited market regulation has resulted in even greater costs for consumers through higher drug prices, and death and suffering through delayed or prevented introduction of new drugs. Yet, Canadians who suffer these costs do not know their cause, and have no incentive to protest the policies of the regulatory authorities.

Is aspirin safe?

These characteristics of the regulation of safety of drugs and many other products in Canada have created the condition where it is almost certain that the social and economic costs of regulation are greater than the benefits. Given rational decisions designed to maximize welfare, the reduction of risk through the regulatory testing of drugs would be pushed only to the point where the marginal benefits in terms of reduced side-effects are equal to the marginal cost of higher drug prices and reduced availability. Under our present system, however, regulators protect their personal interests by pushing the risk reducing tests too far. This point can hardly be dramatized more effectively than by realizing that in today's regulatory climate it could be impossible to obtain approval for the marketing of aspirin.

Economists in recent years have analysed not only the costs of non-market failure due to regulation but also have questioned the magnitude of the market failures. According to this new view, private firms have strong incentives to produce goods that are safe and effective, because if they don't, they lose sales and in extreme cases are forced into bankruptcy. Consumers have the option of assuring themselves of the quality and reliability of goods by demanding warranties or through studying test-results of independent firms or cooperatives. Perhaps more important is the fact that market prices themselves provide useful signals. High-priced goods tend to be not only of higher quality than low-priced goods performing the same functions, but they also tend to be backed by expensive advertising of brands. Through such advertising, manufacturers signal to consumers that if they were to cheat on the quality or reliability of the products, reduced sales and bankruptcy would result in greater losses from the investment in the brand-specific advertising. According to this view, low prices imply low average quality and reliability of goods. This is something that consumers should, and generally do, know. When they choose to purchase the low-priced goods they do so because they prefer to keep the money and take the risk. There is no market failure.

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In sum, the preceding analysis suggests that regulation designed to protect the safety of the consumers of drugs, automobiles, food and many other commodities, and the safety of workers and the general public from the effects of accidents in factories, atomic power stations and similar economic activities provides fewer benefits than the naive view of regulation had supposed. It results in costs that this view had disregarded or underestimated. There is a strong presumption that this type of regulation results in substantial net social and economic costs.

Insurance of risks

In the case of public programs of insurance to provide health, unemployment and retirement benefits, non-market failure arises from what the private insurance industry calls “moral hazard.” This phenomenon is well known generally. It refers, for example, to the increase in restaurant fires that occurs among those insured as compared with those that are not. Similarly, the incidence of unemployment and of illnesses requiring hospitalization is greater among those insured than those without coverage. Moreover, it has been shown that the increased incidence of affliction from the insured hazard is greater, the more of the cost of the affliction is covered by the insurance.

In an important sense, the phenomenon just described has nothing to do with morality. Instead, it represents the simple and rational reaction of people to the lowering of the price of a service brought about by the government insurance. People are able to take advantage of the lower price because contrary to the widely held view of regulation and insurance, the incidence of illness requiring doctor visits and hospitalization, unemployment, and the need for retirement benefits are not determined completely by forces outside the control of the victims. Over some range of symptoms of illness the decision to visit a doctor or enter hospital is guided by the cost of those services to the individual. Over some range of dissatisfaction with a job the decision to engage in behaviour that leads to lay-offs is determined by the cost of being unemployed. The standards of acceptance applied to a job are higher and therefore unemployment is longer, the lower is the cost of being without work.

The existence of moral hazard has caused Canada's real expenditures on health care to be much larger than they would have been if people had been required to pay the true cost for the health services. Unemployment was larger than if benefits had been lower and workers had been forced to borrow more or live from savings during unemployment. This insurance-induced overconsumption represents a form of non-market failure, which has been disregarded or underestimated by the architects of the public insurance schemes. It is responsible to a considerable degree for the high and rising costs of medical care and the unemployment insurance programs in Canada that have called forth many proposals for controlling them in recent years.

Moral hazard in pensions

Canada's pension program is also subject to moral hazard because savings for retirement and the willingness of children to contribute to parents' retirement income are reduced by the knowledge that a government-guaranteed pension awaits. Moreover, there is strong evidence in the United States that the reduced private savings by the insured before retirement was not matched by increased savings by the government. Through the allocative mechanism of the capital market this behaviour has resulted in a reduced rate of real capital formation and therefore productivity growth. It is quite likely that a similar effect has been operative in Canada. The result is a non-market cost that has to be compared with the size of the externalities of private pension plans before government regulation.

Also, it is not clear that publicly provided insurance can be delivered at lower social cost than private insurance, as is argued under the naive view of regulation. Private insurance costs are higher for some people because the insurers classify risks in classes according to the degree of real proneness to accidents as well as moral hazard. Such creation and operation of risk classes is costly but it reduces the overall claims on insurers. The threat of being moved into a higher paying premium class under private insurance rules is a strong incentive against moral hazard. Most public schemes do not have this policy. The observed higher administration costs of private insurance companies thus are not a sign of

inefficiency that can be removed by public insurance. Instead, they reflect expenditures that are more than recovered through reduced costs of moral hazard from a private as well as a social point of view.

Finally, it should be noted that the alternative to public health, unemployment and retirement income insurance is not a total absence of insurance in these fields. The alternative is private insurance meeting the needs of Canadians more flexibly and efficiently than a vast government bureaucracy ever can. Under such a scheme there may well be persons who cannot “afford” insurance against some types of risk, either because they are too poor or because they fall into special risk categories or premiums are “too high.” If these non-insurables are perceived to give rise to great negative externalities, then the government can support the individuals in question. With income grants they can purchase the insurance themselves while private insurance retains its socially desirable controls over moral hazard.

In sum, the preceding analysis suggests that the government provision of insurance in some fields has been justified by biased perceptions of benefits and costs. On the one hand, the benefits from public insurance have been overestimated since higher administrative costs of private insurance largely do not reflect inefficiencies but represent productive expenditures on efforts to curb moral hazard. On the other hand, there are great increases in the costs of public insurance schemes due to the existence of moral hazard, which public insurers cannot curb as effectively as the private industry because of the uniformity of premiums and limits on policing imposed by the political process governing the insurance schemes.

Economic instability

Marketing boards for agricultural products are designed to deal with the problem of unstable consumer prices and producer incomes resulting from seasonal and random disturbances of demand and supply, such as bad harvests and foreign influences. By stabilizing prices they are expected to lower costs of production and thus eliminate a market-failure.

Perhaps more clearly than any other forms of government regulation, marketing boards have given rise to non-market failures. The history of milk-marketing boards is typical of most and can be used to illustrate the social costs these regulatory agencies produce. Upon creation, the boards tend to be staffed by bureaucrats and overseen by a board of government appointed trustees who genuinely wish only to serve the purposes of price and income stabilization. In so doing, they are guided by formulas reflecting dairy farmers' costs of production and reasonable standards of fair returns to them.

The problems begin to arise after a few years of operation. First, the personnel of the boards and the trustees become individuals with a background and stake in the industry. This is so because consumer representatives initially are in a minority on the board and have little expertise to contribute to the technical issues. They are lonely and isolated on these boards and normally resign after only a short time in office. They tend to be replaced by persons either apathetic to or sympathetic with the farmers' interests. We have here the capture phenomenon of regulatory agencies noted above. It persists because the broad consuming public has little or no knowledge about the board's actions. Any costs it imposes on consumers are too small for each one to warrant opposition.

Surpluses

Second, during the first few years of board operation, excess supplies develop. The formulas designed to reflect production costs overestimate, systematically, increases in real costs since they do not take account of farmers' ability to substitute inputs with low or falling prices for those with high or rising prices. They also fail to reflect improvements in productivity resulting from better production technology. As a result, output prices set by the board rise more rapidly than costs of production and there are excess profits. Consequently existing firms and new entrants into the industry expand output even further. This is why all marketing boards with the power to set prices develop excess supplies within a relatively short time of beginning operation.

Efforts to get rid of the surplus production are either costly, such as sale abroad at subsidized prices, or ineffective and costly, such as advertising campaigns. Most marketing boards quickly learn that the most effective and least costly way to deal with the problems of excess production is the imposition of output controls which euphemistically are called “supply management.” These policies usually take the form of quotas and stipulate that a farmer can sell to the board only X per cent of the amount sold in a preceding period, where X is set to eliminate the surplus. Thus, if supplies exceeded demand by 10 per cent, then X is set at 90 per cent. These quotas can be translated readily into a right to sell a certain number of litres of milk per day to the board at the officially set prices.

The introduction of a quota system usually is very successful in eliminating excess supplies, but farmers don't like it initially. It lowers profits and creates excess capacity. They appeal to the board for higher prices in order to maintain a fair return. Board trustees understand the farmers' plight and agree to increased prices by changing formulas or using some other ad hoc arguments. Returns to farmers are again normal (or fair in the typical terminology), there are no surpluses and prices for consumers are stabilized.

Quota values as measures of excess profits

However, in a world of constantly rising prices and technological improvements, output price increases continue to outpace true increases in the cost of production. Owners of quotas make ever higher profits that are unavailable to others. Eventually, a market for quotas develops. Quota prices reflect quite accurately the capitalized value of the excess of revenue over production costs to which holders are entitled. Proceeds from the sale of quotas accrue to farmers, not the marketing boards and the public. New quotas are not sold but given away by the boards when demand expands and farmers have met certain conditions that are equivalent to having made an investment about equal to the market price of the quotas.

In a case study of the B.C. Milk Marketing Board it has been found that the value of quotas increased at an annual rate of 80 per cent between 1977 and 1980. In 1980 a dairy farm of 50 cows was required to own quotas whose market

price came to about \$250,000. The interest cost on this money alone amounted to 25 per cent of the revenue from the milk sold by such a dairy farm. This fact implies that all other costs of production and normal profits were at the most 75 per cent of the price of milk paid to farmers by the board.

The preceding analysis and data illustrate the non-market failure of government regulation designed to deal with economic instability in agriculture. Similar stories can be told about the nature of import quotas designed to reduce economic instability caused by imports in certain industries such as clothing, shoes, cheese, and bicycles. The main costs are elevated consumer prices and the large scale transfer of income from consumers to producers holding the quota rights. It should be noted that these income transfers are not subject to the normal process of political control required of other income transfer programs. Efforts by consumer interest groups to change quota systems in Canada have failed periodically because they cannot generate enough support. Costs for every person are so small that there is little return to political action.

Non-market failure of quota systems

Agricultural and industrial quota systems as tools of supply management not only impose great direct costs on consumers, they also give rise to negative externalities. The capital required to purchase quotas raises the cost of entering the farming business. This accelerates the trend away from family farming and towards agro-business that is deplored by many people as worsening the cultural and social characteristics of rural life in Canada. Processors of farm products cannot purchase their inputs from least-cost producers since prices are uniform and output is allocated by the boards. As a result, the more dynamic and efficient processors cannot increase their business. Consumers lose the benefits of lower costs of processing by such firms. In addition, supply control cannot be effective unless imports from other regions in Canada and abroad are prohibited. As a result, marketing boards have erected barriers to inter-regional and inter-provincial trade and imports from other countries. These barriers seriously reduce the benefits

accruing to Canadians from trade and regional specialization in production. Analogous arguments can be made about the costs of quotas on imports of manufactured goods. All of these negative externalities of government control and regulation have been neglected or underestimated by proponents of the naive view of regulation.

Lower cost of market solutions

At the same time, this naive view has tended to overestimate the magnitude and costs of instability under free markets. Free market prices are stabilized by the action of industry specialists carefully weighing the evidence on future trends in demand and supply. Professional speculators buy at low and sell at high prices, storing goods or holding short positions to achieve their goals. As a result, prices fluctuate less than they would have in the absence of speculators. Remaining price fluctuations in free markets are the result of unforeseeable influences on demand or supply. There is no evidence to suggest that public employees running price stabilization schemes are any better at forecasting what for private speculators are unforeseeable influences on demand and supply. That is the reason, of course, why public price stabilization never is very successful except as its purpose is perverted and downward trends that would have “marred” the private market are eliminated.

In sum, regulation of free market processes designed to reduce economic instability and lower production costs is typically not very successful in improving on the stability generated by private markets. Success comes at the expense of prices that are too high and rise too quickly, resulting in excess supplies that have to be suppressed by supply management through the use of quotas. The attainment of this increased stability involves costs that were either neglected or underestimated by the proponents of the naive view of regulation: consumer prices that are too high and lead to a redistribution of income from consumers to quota holders. In addition, the regulation creates barriers to competition and reduces incentives for technological improvements and specialization.

Methods for Dealing with Non-Market Failures

Economists who accept the validity of the preceding analysis typically suggest either reform or complete or partial deregulation. Suggestions for complete deregulation are made most frequently in cases dealing with uncertainty and natural monopoly.

In the United States something like complete deregulation has been achieved only in the airline industry. Results have generally been interpreted as evidence in support of the arguments about the benefits of deregulation presented above. The analogous deregulation of other forms of transportation such as railroads, river barges, trucks, and buses has faced stiff political opposition from the alliance of interests that are certain to lose monopoly benefits, in spite of the success of the airline experiment.

Chances for complete deregulation in Canada of any natural monopolies is smaller than in the United States. The involvement of the Canadian government in the economy has a stronger tradition and wider public acceptance than in the United States for historic reasons. These reasons are primarily the influence of British economic and political thought and the parliamentary system of government. The federal government in Ottawa has responded to the challenge of the ideas about non-market failure of regulation by creating task-forces of bureaucrats and politicians charged with evaluating the problem in the Canadian context. The reports of these task-forces criticised the deregulation on two important grounds.

First, they claim that regulation achieves many social benefits that would be costly to achieve in other ways. For example, marketing boards increase rural income and preserve industries that would otherwise be wiped out to the detriment of a secure, national supply of food. The regulation of the transportation industry has led to the development of Canada's North for the benefit of overall economic growth, the exploitation of natural resources and national defense.

Second, the Canadian task-forces have concluded that in this country regulatory authorities are really under direct political control and therefore much more responsive to needs of the public than are U.S. authorities that, once

created by legislation, are restrained only by judiciary interpretation of the limit of their power.

These views on the merit of deregulation in Canada come as no surprise since they originate from task-forces of people whose self-interest is served by the continuation of existing conditions. But they do reflect also real differences in Canadian-U.S. attitudes on the subject that are held by the public and many intellectuals. As a result, it is highly unlikely that in the near future there will be any industries freed completely from regulation in Canada.

Partial deregulation in the United States

Partial deregulation and improvements in the regulatory process are recommended usually in the cases of regulatory controls of environmental pollution, product safety, insurance, and economic instability. Such reforms of regulation have considerable political appeal. They are suggested or undertaken whenever gross excesses of regulation build up public pressures.

For example, U.S. regulations concerning the seat-belt system in new automobiles were relaxed when consumers complained with sufficient vigor about the inconvenience of inter-locking belts, buzzers, and ignitions. The same applies to regulations concerning smoke emission by coal-fired power stations and the reconstitution of the surface of strip-mines. These were changed when costs had obviously become excessive and conflicted with goals of national energy self-sufficiency. Excessive zeal used in the enforcement of health and safety legislation was interpreted as unreasonable harrassment by many small business firms. This led to executive directives for the moderation of procedures. Excessive regulation was an issue in the 1980 election campaign that brought President Ronald Reagan into power. He had promised to carry out reform and reduction in regulation.

Canadian reform efforts

There have also been some efforts to modify regulation in Canada. The most important of these concerned the financial sector. Changes in the Bank Act have increased competition among banks, trust companies, savings and loan

associations, and foreign banks. Legislation changing the post-office to a crown corporation from a government department was designed to make its operation less subject to direct political pressures. The B.C. Milk Marketing Board prohibited trade in market quotas but later relaxed this ruling again. Eligibility for unemployment insurance is reviewed and tightened periodically as abuses of the system are exposed. In general, however, regulatory reform in Canada has failed to become an important political issue. By and large regulators continue to act as if there had been no revolution in the thinking about regulation and that it leads to nothing but a correction of market failures at completely justified and small costs.

It is possible that the conservative U.S. government under President Reagan will be able to deliver on its election promise and introduce deregulation and reform. If these policies are successful, they will undoubtedly lead to calls for similar policies in Canada. However, I remain sceptical about the likelihood that deregulation and reform will be substantial in either Canada or the United States for reasons that are obvious from the analysis of this chapter. Deregulation and reform injure too many vested interests and regulation retains powerful intellectual support from those who continue to believe that economic engineering can succeed in bringing the ideals of romantic socialism to the two countries' economies.

Free Economic Zones as Partial Deregulation

All of the preceding analysis stands as the justification for the proposal that partial deregulation be achieved through the establishment of free economic zones. More precisely, such zones are justified if non-market failures are great and if deregulation and regulatory reform either are prevented or are unsuccessful. The free economic zones can serve as both a substitute for and complement to whatever deregulation or reform is achieved.

Free economic zones are geographically defined areas within which industries can operate in the absence of certain types of regulation. For example, such zones may be devoted to manufacturing and trade which are unrestricted by import tariffs, and quotas, excise taxes, minimum wage

legislation, unemployment and retirement benefits for workers and so on. They may also host medical and gambling industries. The deregulation can also be applied to specific economic activities of firms set aside not geographically but through the separation of customers with special characteristics. Such a definition of a zone is appropriate for banking, insurance and investment industries.

The nature of deregulation and the economic and welfare effects of the creation of such zones and industries will be discussed fully in the next chapter. Here remains the task of pointing to the general advantages of deregulation by this method, which makes it a substitute for or complement to the deregulation or reform discussed above.

The most important advantage of free zones and industries is that they permit society to retain regulation for certain types of activities that are deemed to require it, while allowing other activities to reap the benefits of free competition. As a result, for interests that benefit from regulation and other proponents of regulation, free economic zones are politically palatable. Free economic zones take the pressure off demands for general deregulation or reform and should be welcome on these grounds. Moreover, interests benefiting from regulation may well be induced to participate in the new economic opportunities generated in the zones, especially if they are at the expense of foreigners but also if they come through the expansion of traditional business. Furthermore, government revenues may be affected favourably. As a result, opponents of general deregulation and reform may well see the creation of free zones to be in their self-interest.

Other beneficiaries of partial deregulation through the creation of the zones are consumers who will have a greater choice of goods and services at lower prices. These consumers are identifiable and can readily band together to support creation of the zones.

A laboratory experiment

At the most general level, but important in the historic context of regulation, the zones represent experiments that permit empirical observation of the costs and benefits of deregulation. Without these zones much of our knowledge

of necessity remains largely untested. Such empirical results should make it possible to make more rational decisions about the extent and nature of regulation in the future. Therefore, intellectuals and others interested in reliable knowledge about the real world should welcome the experimentation made possible through the creation of free economic zones. If, in fact, the above analysis of the great cost of non-market failures of regulation is correct, then the zones should create valuable and new information and render regulatory policies more enlightened.

However, the opposition to the creation of free economic zones should not be underestimated. Bureaucrats and politicians dislike taking risks and the creation of zones entails this since their total effects are uncertain. If the zones succeed, they may be interpreted as evidence that the bureaucrats and politicians did not previously act in society's best interest. Some opposition may be based on such a possibility. Moreover, if the zones are very successful, they will be so in part at the expense of the interests benefiting from existing regulations. At the same time, the beneficiaries of deregulation in the zones will become vested interests who will become strong supporters of further growth of zones.

In sum, while deregulation through the creation of free economic zones has several practical and political advantages over conventional deregulation and reform, opposition to the free zones can be expected to arise from some vested interests and politicians who face the risk of losses of benefits.

CHAPTER 3

TOWARDS A THEORY OF FREE ECONOMIC ZONES

This chapter contains the core of a paper published under the chapter's title in a journal, *Weltwirtschaftliches Archiv*, 1, 1982. It describes somewhat more rigorously than in preceding chapters the nature of partial deregulation through the creation of free economic zones. It also analyses the political economy and welfare effects of such zones. In a sense, this chapter represents the intellectual core of this study.

Analytical Description of Free Economic Zones

Free trade zones

Free trade zones are areas separated from the surrounding host country's territory by fences or other barriers into which goods from abroad can be brought without quota restrictions or the payment of tariffs and excise taxes, and without being subjected to exchange controls, and to the majority of statistical reporting requirements and regulations aimed at the protection of consumers. Goods can be stored, used in manufacture, exhibited, assembled, sorted, and sold in such zones. But these processes are subject to the host country's normal laws governing environmental protection, workers' safety and employment conditions. Profits and wages earned in the zones are taxed at regular rates. Goods can be exported as freely as they are imported. However, when goods are brought into the zone's host country, they are subject to the normal import quotas, duties, and excise taxes.

In practice, free trade zones may be as small as a retail store in an airport or as large as the territory of Hong Kong, and they may serve the simple function of warehousing or may contain a broad spectrum of industries. The essential feature of free trade zones for economic analysis is that they lower the host country's level of protection through the reduction of tariffs, quantitative barriers and administrative hindrances to trade.

When a free trade zone consists of only a warehouse, it is often called simply a "bonded warehouse." In the United States in recent years factories, such as the one assembling Volkswagen automobiles in Pennsylvania, have been declared free trade zones. In some instances, as in Panama, the free trade zones consist of a large area containing industries of many types. There are also free trade zones devoted to retail stores only, as at many international airports and harbors. According to our definition, Hong Kong represents one very large free trade zone. The Hanseatic cities of Northern Europe and the Free Cities of Germany, similarly used to be large free trade zones.

In developing countries we find also so-called "industrial estates" and "export processing zones." They have all of the characteristics of free trade zones as described. But in addition, they often provide subsidized services and facilities to occupants. One such service of great value often provided is an agent that deals with the host country's bureaucracy in the name of the zone's occupants (UNIDO, 1980).

The lowering of protection takes place when a firm imports goods into the free trade zone, processes or assembles and then exports them. The firm saves the duty on these imports and for these goods the host country's tariff revenues and therefore average tariff rates are lowered. The savings for the exporter and therefore the practical reduction in duty burden from operating in the free trade zone usually is only equal to the opportunity cost of the duty paid. This is because in most countries a system of duty drawbacks returns customs paid on all exported intermediate inputs. However, it should be noted that the economic effect of these savings for exporters may be quite significant since they are relevant to the export activity's value-added base.

Therefore it is important to evaluate all of the reductions in protection in terms of the concept of effective protection as developed by Corden (1971).

Reduced tariffs

Many countries have rules under which certain imported goods are assessed at a specific rate, but if these same goods are embodied in a product that has a certain domestic value-added percentage, then they enter at a lower tariff rate. Activities in free trade zones often contribute this required percentage of domestic value added and therefore indirectly lead to the lowering of tariff rates. This characteristic of U.S. tax laws explains why several foreign automobile assembly plants in the United States have been made into free trade zones. When imports are subject to quota restrictions, then they can be stored in free trade zones and imported whenever quotas become available. As a result, the effective import restrictions implicit in a given quota are lowered.

Importers value highly other effective duty reducing benefits provided by free trade zone operations. For example, defective goods can be destroyed in the zone before a shipment is imported into the host country and duty is assessed. Free trade zones serve as showrooms for customers. In Hamburg oriental carpet dealers regularly take customers to their large warehouses in the duty free zone. In New York a free trade zone on a dock serves as an exhibition ground for sellers of machinery. Customers can bring samples of goods there for a demonstration of the processing capabilities of the equipment. Diamond (1979) provides an extensive list of benefits for exporters and importers located in free trade zones in a form useful for agents promoting a free trade zone. The sources of reduced operating costs noted here are merely samples designed to make a general point. There are many others. In addition there are savings in costs of dealing with customs and tax authorities which for small firms often are relatively large.

At the end of 1979 there existed 344 tax-free trade zones, free ports and similar designated areas in 72 countries of the world. In the United States there were about 50 such zones and plans existed for the creation of many more.

It was estimated that in 1979 about \$100 billion of total world trade of \$1300 billion went through free trade zones. Forecasts are that by 1985 about \$300 billion or 20 per cent of world trade would pass through such free trade zones (Diamond, 1979).

Free banking zones

Euro-currency banking. It is now widely accepted that one of the primary causes of the rapid growth of Euro-, Asia- and Latin-American currency banking since the 1960s is the exemption which this type of banking enjoys from the taxes implicit in minimum reserve requirements. That this is so can readily be seen by consideration of the following simplified example.

Consider a bank located in Montreal which pays interest on deposits at the annual rate of 8 per cent and therefore pays \$8 on a \$100 deposit. Faced by an assumed 15 per cent reserve requirement this bank can lend out only \$85 of the deposit and if the loan rate is 10 per cent it earns \$8.50. Under these conditions the \$100 intermediation business brings the bank net operating revenue of $\$8.50 - \$8 = \$.50$. Assuming that operating costs for labour, etc. constitute \$.45, the before income tax net profit is \$.05 per \$100 deposit.

Now assume that this bank opens a branch in London, England, and persuades its customers to do business there in return for a marginally higher deposit and marginally lower loan rate. For the sake of simplicity we assume that this margin is so small that in the present calculation it can be disregarded. Under these assumptions and remembering that there are no legally required reserves on foreign currency deposits for banks located in London, the net operating margin of the Montreal bank branch on a \$100 deposit is $\$10 - \$8 = \$2$, which is four times what the parent bank could earn in Montreal. If labour and other costs are the same \$.45 per \$100 of intermediation in London as in Montreal, the London branch shows a before income tax net profit of \$1.55. Shifting business from the taxed and regulated home base to the free banking zone in London therefore implies an increase in the bank's net profit margin of over 3,000 per cent. Analogous increases in net profit mar-

gins are available to banks in most countries on deposits and loans made in foreign currencies.

In fact, the spread between lending and borrowing rates in Euro-currency markets in individual currencies is narrower than that found in the currencies' home countries by an amount equal approximately to the implicit cost of the respective countries' reserve requirements. In effect, customers are reaping a large share of the benefits of the taxes saved. Portfolio balance considerations of banks, lenders and borrowers prevent perfect arbitrage between the rates in domestic and Euro-currency markets. However, the illustrative calculations are indicative of the strength of the incentives facing banks to escape domestic regulation, which persist as long as lending and borrowing spreads are determined in the domestic markets.

The preceding example illustrates the strength of the incentives facing banks to enter the Euro- and other regional currency business and explains why this type of banking has grown from practically nothing in the 1960s to over \$1,500 billion in 1980. For our purposes of analysis it is important to note that it involves a partial deregulation through the lowering of an implicit tax on a type of business that can be kept separate from regular and regulated other business in two ways. First, the deregulation applies to business transacted in a geographically defined area, similar to the case of free trade zones discussed above, but with the important difference that in practice all of the rest of the world is the free economic zone. (Germany is the exception since that country's banking laws require the maintenance of reserves on deposits in all currency denominations. As a result, Germany harbors practically no Euro-currency banking business.) Second, the deregulation applies to a certain type of business, namely foreign currency deposits, even though it may take place within a geographic territory where the banks' other business is fully regulated.

Free banking zone in New York

In the year 1981, after many years of negotiation, a free banking zone was opened up in New York (Cheng, 1981). If it is successful, more such zones will be created in other U.S. centres of finance. The basic idea behind the estab-

lishment of these zones is the removal of reserve requirements on banks in order to induce a return to the United States of some of the business that has been lost to the rest of the world through Euro-currency banking. The problem faced in the establishment of these zones is how to prevent massive shifts of domestic business into them. This would produce serious inequities between ordinary banks and those operating in the zones. In addition, such shifts would raise the reserve-deposit multiplier and create problems for U.S. monetary policy.

The adopted solution to these problems is that banks are freed from U.S. reserve requirements only on deposits in large denominations owned by non-U.S. residents. This particular method for the separation of deregulated from regulated business is likely to limit severely the growth of business in the U.S. free banking zones, though in the end their chances for success involve an empirical question which only actual operation of the zone can provide.

It should be interesting to discover how enforceable the foreign residence requirement is in preventing shifts of domestic business in the zone, given the well-known ease with which funds can be funnelled through foreign branches and subsidiaries. Also, given the low cost of information transmission, it is likely that new institutions can be developed which permit effective circumvention of the legislation restricting U.S. residents from use of the zone.

Free insurance zone

During the great wave of regulatory fervor in the postwar years all industrial countries have imposed increasingly more severe restrictions on the operation of insurance companies. During this period Lloyds of London grew rapidly because it constituted a haven free from regulation.

Lloyds has attracted mainly two types of business from other countries. First, there are the special risks for which there are few or no experience ratings, such as the cancellation of Olympic Games broadcast opportunities and the cancellation of computer leasing contracts. Second, there are the very large risks of insuring super-tankers and large-scale industrial projects. Lloyds has not attracted from other countries the standard fire, accident and life insurance

business for which the local availability of agents is of paramount importance.

It is clear from the preceding description that an effective separation of regulated and deregulated insurance business has taken place in the world. Routine business involving large numbers of relatively small accounts has remained under the control of national regulatory authorities largely because transactions costs of dealing with Lloyds are too large. Special and very big risks, on the other hand, have been shifted to Lloyds either because in the case of special risks the advantages of deregulation are great, or in the case of very large routine risks, the transactions costs for the insured multinational enterprises are small.

The New York free insurance zone

In 1980 New York opened a free insurance zone (Decaminada, 1979; *The Economist*, 1979). Similar zones may well be established in other U.S. cities. In the New York zone resident insurance companies can underwrite risks that require a minimum annual premium of \$100,000 without obtaining the permission of regulatory authorities of the State of New York. In addition they can underwrite many special risks which have been identified by the authorities. These have the common characteristic that regulators in the past have been unable to ascertain promptly and reliably that premiums charged and other conditions of the contract protect the consumer and assure viability of the underwriters. Because of the regulatory delays and costs, such risks in the past have been insured by Lloyds.

The intent of the New York free insurance zone is clearly to return some of the business that has been lost to the deregulated environment abroad by offering similar deregulation to New York firms. But through the specification of the nature of deregulated business, an effective separation between regulated and deregulated sectors is assured. Some doubts have been raised about the likely success of the New York insurance deregulation experiment (*The Economist*, 1979) on the grounds that the success of Lloyds has been due not only to a favourable regulatory environment but also to the special expertise and financial structure of the firm. (Partners in Lloyds face unlimited liabilities.) It

remains to be seen how successful the New York free insurance zone will be in exploiting the benefits of deregulation and accumulating the required expertise.

Free gambling zones

The State of Nevada constitutes a free gambling zone. It was created in 1931 when the sparse population of the state and its distance from centres of population amounted to the effective separation of markets. Only well-to-do people who could afford to travel to Nevada would be exposed to the risk of deregulation while the masses of ordinary citizens continued to be protected by the regulatory umbrella.

The establishment of gambling casinos in Atlantic City was approved and undertaken in the same spirit as Nevada's, though the strength of the possible discrimination between regulated and deregulated customers is much weaker. Still, in contrast with totally free gambling, limited free gambling in Atlantic City significantly reduces the exposure of ordinary citizens to the temptation of the activity. Already existing proposals for the establishment of other gambling centres in the United States suggest that if the Atlantic City experiment is successful, they will be established not in large urban centres but in relatively small resort centres where access by ordinary citizens is limited.

In Europe, where for a long time there has been less regulation of gambling than in the United States, big-time organized gambling through roulette and card games has been permitted only in casinos located in famous 19th century spas such as Baden-Baden and Monte Carlo. These were in the past frequented by royalty and gentry and even today access is rather difficult for ordinary citizens. British gambling clubs require membership fees that represent a barrier to use by local residents of moderate means.

Free enterprise zones

It is widely accepted that the decay of city cores in Britain and the United States is due in a very significant degree to regulation of business, which affected especially small business and the employment it provided traditionally (Butler, 1980). In Britain legislation has been passed that led to the designation of some depressed urban areas as Free Enter-

prise Zones. In these zones a number of burdensome types of regulation and taxation have been eliminated. The U.S. Congress is debating legislation that would permit the establishment of such zones in depressed U.S. cities.

The need to create effective separation between regulated and deregulated business has given rise to as yet unresolved problems in the formulation of the U.S. legislation. It has led to problems with the British zones since discrimination in essence is based on geographic location. As a result, the borders of the zones create strong discontinuities. They have induced some business to move from outside the zone into it. In the process they have created a belt of depressed activity and real estate values around the zones. In addition, the zones can develop into tax-havens for large firms. It remains to be seen whether it will be possible to create legislative mechanisms that allow the effective discriminatory deregulation and tax reductions. These must be channeled properly for the achievement of the stated objective of stimulating the establishment of new small enterprises without generating costly additional regulation.

The Political Economy of the Free Economic Zones

The preceding description of the types, characteristics and growth of free economic zones raises the question of why they have been permitted to develop in the past when there was generally strong faith in the need for and ability of regulation to improve free market institutions. Furthermore, the question arises as to why they are growing so rapidly in number in recent years when, after widespread realization of the high cost of regulation, efforts to achieve general deregulation have been stalled? In this section I will provide provisional answers to these questions arguing first that free economic zones are an instrument for selective deregulation and second, that they generate powerful interest groups which assure political success.

Selectively targeted deregulation

Regulation is basically a blunt instrument. For example, foreign trade restrictions bring costs to all regions of a country while often benefiting only a few. This proposition holds

in the case of tariffs on automobile components, which benefit an industry that is often concentrated regionally, but the tariffs raise the cost of automobiles and automobile assembly, harming the interests of other regions, including some which under free trade might have a comparative advantage in automobile assembly. Similarly, regulation often provides paternalistic protection for consumers whether they need it or not. For example, in the insurance underwriting business for large tankers, it is reasonable to assume that the buyer does not need the state's protection concerning rates charged and the fiscal soundness of the insurer. In contrast, there is a much stronger case for protecting the public from the sellers of life insurance policies that use unethical selling techniques and invest customers' funds fraudulently or unwisely. Also, the case for protecting the uneducated and poor from the temptations of gambling is certainly greater than that for protecting the wealthy. (None of the above examples are to be interpreted as making an absolute case for regulation. I think that the argument about the need to protect the poor but not the rich from the temptations of gambling is paternalism of the worst sort since it is combined with elitism.)

The preceding examples suffice to make the case that regulation is basically a blunt instrument that cannot readily be applied to meet the special requirements of particular regions and groups of people. Seen in this light it is clear that free economic zones represent an instrument for the selective application of deregulation, permitting in principle the development of an optimum pattern by regions and classes of customers.

However, free economic zones are a useful instrument for selective deregulation only if two conditions are met. First, there must be a need for it and second, it must be technically feasible to achieve a separation of the regulated and deregulated market. In the case of the examples cited above, these two criteria appear to be met, except in the case of free enterprise zones where it is not clear that it is technically feasible to limit deregulation to the economically relevant firms.

Interest group banking

It is well known that the deregulation of some U.S. industries has been stalled because it lowers the welfare of some firms and workers clearly and by a substantial amount. It is worthwhile therefore for these people to form well-financed interest groups lobbying with politicians, and presenting them with a credible threat of the loss of blocks of votes in case their industries are deregulated. The beneficiaries of the deregulation, on the other hand, usually are large in number and would gain very little each from deregulation. As a result, they have no incentives to form interest groups and lobby with politicians for deregulation. Consequently, even in cases where it is widely accepted that the sum of small benefits exceeds the large costs to a few, the political process of deregulation is often stalled.

The preceding model of the political economy of regulation, however, can be used to explain why in the case of industries where complete deregulation is stalled, partial deregulation through the creation of free economic zones has been accomplished successfully. The reason is simply that the free economic zones generate benefits sufficiently large and concentrated for some firms, workers, and local governments. It is profitable for them to form interest groups for lobbying with politicians in favour of the zones. The costs created by the zones, on the other hand, tend to be small and diffuse and therefore do not generate strong interest groups and political opposition.

The Volkswagen case

The preceding considerations can be illustrated by reference to a free trade zone. When the Volkswagen company considered establishing an assembly plant in Pennsylvania, local workers, small businesses, and governments stood to benefit a great deal. They formed a powerful lobby that succeeded in obtaining legislation which granted free trade zone status to the VW assembly plant. The producers of automobile parts in Michigan whose level of protection was lowered through the free trade zone suffered only marginally and in ways which were difficult to establish quantitatively. If they tried to lobby against the Pennsylvania zone, they

obviously did not succeed because they were unable to generate a credible voting threat.

In the case of the free banking and insurance zones the pattern of interest group pressures was even more favourable. Most of the firms in the zones are branches of existing U.S. firms, which expect no reduction in business done in the regulated sector in the United States. Instead, they expect to gain at the expense of foreign firms and by bringing home business that had been lost to partial deregulation abroad. As foreigners have no votes in U.S. elections, opposition from these interests was ineffective. The main battle was in persuading domestic firms unable to open branches in the zone that the planned techniques of discrimination would be successful in preventing loss of business from the regulated sector. For this reason the New York free banking zone was long delayed by opposition from U.S. banks which were prevented by federal law from opening branches in the zone and which feared that the zone would divert business away from them.

Welfare Effects of Free Economic Zones

The creation of free economic zones raises welfare through the more selective application of regulation according to the requirements of different regions and groups of customers. In real terms, the deregulation lowers costs of protection and of transactions, permitting welfare gains through the expansion of trade and specialization. Free economic zones are likely to have dynamic effects on the supply of work, technology and entrepreneurship.

However, free economic zones also may reduce welfare through the locational diversion of trade and investment and through the generation of negative externalities. In addition, there are welfare effects of an indeterminate sign due to the redistribution of tax revenue between governmental jurisdictions.

Theoretically, the overall, net welfare effects of free economic zones are indeterminate. Only empirical studies can lead to estimates of net benefits and it is doubtful that some of the effects can ever be measured. Perhaps it will be possible to employ the methodology used in the empirical

study of the effects of trade diversion and creation in connection with economic integration. In these studies externalities and tax effects have also been ignored or treated as residuals. Hodjera (1978), Johnson (1976), and Grubel (1980) have attempted cost-benefit studies of regional free Euro-banking centres.

Real economic effects

As was shown above, the creation of a free trade zone amounts to the lowering of the level of protection of the host country. It is well known from the theory of international trade that such a lowering of protection leads to increased levels of trade and specialization, which in turn results in higher community welfare. This proposition is illustrated with the help of the standard Heckscher-Ohlin model in Figure 1, where the small home-country's import good X and export good Y are measured along the horizontal and vertical axes, respectively. In initial equilibrium, production is at point P_0 on the production possibility locus XY, where the protection-distorted domestic relative price line TT' is tangent and the relative price of the traded good is equal to the marginal rate of transformation in production. Trade takes place along the world price line WW' and permits attainment of welfare level C_0 , where the domestic price level is equal to the marginal rate of substitution for consumers.

The lowering of protection due to the creation of the free trade zone is assumed to result in the new domestic price ratio T_1T_1' and the new equilibrium output at P_1 and consumption C_1 after trade at the unchanged world price WW' . The core of standard international trade theory consists of establishing rigorously that consumption point C_1 must imply a higher level of welfare than C_0 . It follows therefore that if the creation of a free trade zone leads only to the lowering of protection and has no other effects, a small country must gain welfare through the increased specialization in production which exploits its comparative advantage. However, the lowering of protection through the creation of a free trade zone does have another effect which requires amendment of the standard model and results.

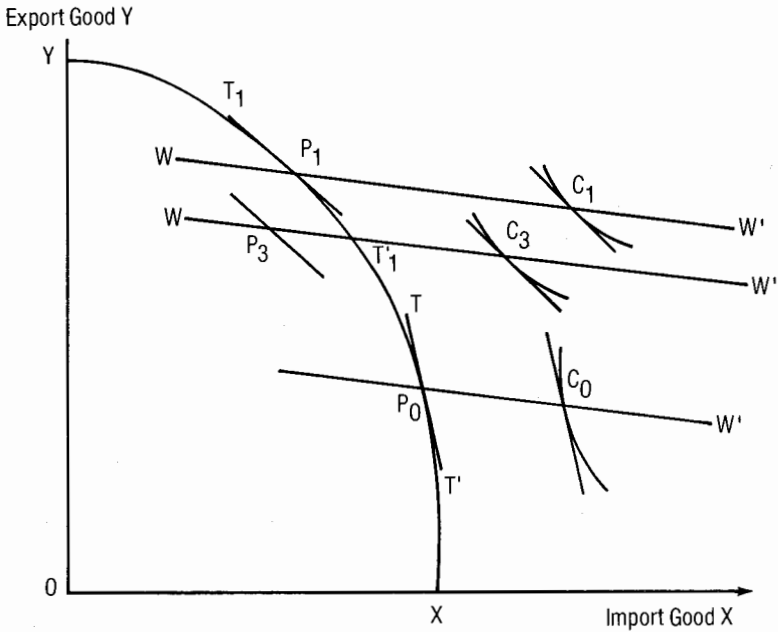


Figure 1
Trade Creation and Locational Trade Diversion

Note to Figure

Free trade zone creation lowers domestic protection and changes the domestic price ratio from TT' to $T_1T'_1$ and production from P_0 to P_1 , resulting after trade at the world price ratio WW' in a gain of welfare from C_0 to C_1 . However, if the free trade zone induces the inefficient location of production, output may move from P_0 to P_3 and welfare gains are smaller and may even lead to losses, shown as $C_3 < C_0$.

Locational trade diversion

The elimination of protection in the free trade zone may induce production to take place in an inefficient location. This will result in extra costs of production that lower the level of welfare below that which the country could attain if the same reduction in protection had been available uniformly to all firms regardless of location. Two examples may serve to illustrate this important point. First, when bank intermediation business is induced to shift from Montreal to London through the absence of the reserve requirement tax, several extra real costs of doing business are incurred because the London branch of the Montreal bank has to be staffed and supervised over great distances from the parent's headquarters. Lenders and borrowers incur extra costs of communication or travel or perhaps just legal complications by dealing in London rather than in Montreal, where by assumption in the absence of free banking in London they would have done their business at least cost. These added social costs of Euro-currency banking must be offset against the social gains. These accrue because the smaller spread between lending and borrowing rates in London induces some extra lending and borrowing and makes capital markets more perfect. It should also be noted that the private incentives for doing business in London rather than Montreal remain in spite of these extra social costs, for otherwise the shift of the business would not take place.

As a second example, consider the Swiss village of Nandans, which is located in a high valley between Switzerland and Austria. Because of difficult access from Switzerland in the 19th century, this village was granted exemption from Swiss excise taxes and tariffs. In essence, it is a free trade zone which attracts much business through offering low prices especially in heavily taxed and protected gasoline and cosmetics. The economic waste created by this free trade zone is readily apparent as one envisages heavy gasoline trucks slowly lumbering up the steep mountain road to the village. These trucks are followed by long lines of private passenger cars. Once in the village the gasoline is transferred into the tanks of the passenger cars via the pumps of tax-exempt gas stations. After this transfer the cars and trucks return to the lowlands for regular, produc-

tive work. It is clear, that the free trade zone induced business in Nandans is privately profitable, but that it involves a relatively substantial waste of real resources.

Welfare loss

In terms of the model in Figure 1, the inefficiencies caused by the locational diversion of business are shown by production taking place at point P_3 , which is inside the efficient frontier. While trade still takes place at the world price line WW' , the point of consumption C_3 must necessarily be below C_1 because the only difference between the two situations is that C_1 is reached without the inefficiency cost of the locational diversion of business. Whether or not C_3 is on a higher indifference curve than C_0 is an empirical question that depends on the relative magnitude of the gains from trade creation and the losses due to the locational diversion of trade. However, it cannot be ruled out on logical grounds that locational diversions of trade result in a net loss of welfare by the criteria of the standard trade model.

The results of the analysis focusing on the concepts of trade creation and locational trade diversion are strongly reminiscent of results obtained in the analysis of the effects of economic integration (Lipsey, 1960). In fact, we have here simply another case of the second-best and reconfirmation of the basic principle that partial movement towards free competition does not necessarily result in greater welfare. However, the results of second-best policies are ultimately an empirical matter. In this context it may be useful to note that most studies of the effects of European integration concluded that trade expansion dominated by far trade diversion effects. However, only actual studies of free trade zones from this point of view can establish whether the beneficial effects of integration also prevail in the case of free trade zones. No such studies have been brought to my attention.

Defensive deregulation

At this point of the analysis it is important to introduce a distinction between what might be called offensive and defensive free economic zone creation. When a free trade zone is created in a country we have the offensive case for which all of the preceding conclusions about trade creation

and diversion are relevant. However, the creation of the free banking and insurance zones in New York involve a defensive act in the sense that they are a response to prior deregulation abroad in the form of Euro-currency banking and Lloyds of London, as described above. Therefore, these U.S. free zones reverse some of the locational diversion of trading that the prior deregulation had produced. They are more likely to raise welfare than are the offensive zones.

Generally, the preceding analysis suggests that the costs of trade diversion are likely to be the smaller the more free economic zones there are. Taken to the limit, the number of zones will be so large as to include all of the country's territory, and in effect universal free trade is achieved with zero costs of trade diversion.

In this context, it is worth noting that the "underground economy," which recently has become the object of much study (Feige, 1979; Mirus and Smith, 1981) is a form of free economic zone. It, too, involves welfare gains and losses that are analogous to those of free economic zones just discussed. Deregulation that causes economic agents to leave the underground economy are defensive and can lead to a lowering of existing locational diversion costs. Free gambling zones may well have this result if they induce gamblers and the suppliers of gambling services to give up their illegal activities, creating social savings in the form of less crime and corruption.

Capital flows

Free economic zones generally, but free trade zones in developing countries especially, can give rise to capital flows which have potentially important welfare implications. As is well known, regulation and protection in many developing countries represent serious barriers to the inflow of capital, even if local labour productivity would otherwise make such investment profitable. The establishment of a free trade zone which removes these barriers can induce the inflow of capital. This raises the productivity of local labour, may generate dynamic linkage effects and gives rise to income tax revenue from the profits of foreign firms. All of this translates into gains in welfare for the host country. At the same time, the owners of capital in the rest of the world gain since their private yields are increased.

The growth in world welfare caused by the more efficient global allocation of capital is, in addition to that of the gains due to the more efficient allocation of given resources in each country, discussed in the preceding section. However, as in the case of the effects involving given resources, the flow of capital can result in costs of locational diversion. For example, foreign capital which has located in the Philippines' Bataan free trade zone might have located elsewhere in the Philippines, if deregulation had been uniform for the whole country. If this is the case, the productivity of the capital is lower than it would have been if it had located in the most efficient place. In the extreme, if the foreign capital comes from a regulated environment, the true social productivity in that zone may be lower than what it was in its country of origin. Again, as in the case of the analysis of the effects with given resources, the net welfare effects of capital flows induced by free economic zones on the host and home country are a function of the empirically determined relative effects of creation and diversion.

Dynamic effects

All of the preceding arguments about the welfare effects of free economic zones are essentially static. They consider the results of induced changes within the analytical framework of given resource endowments, technology and the efforts of workers and entrepreneurs. This approach misses what in the longer run may be the most important source of benefits of free economic zones, the dynamic effects. While they are notoriously difficult to predict or even to identify, their importance was stressed in empirical studies of the effects of integration, and they underlie the widespread interest in supply side economics in the 1980s. The dynamism generated by selective deregulation has already manifested itself in the more rapid and frequent innovations in banking and insurance services offered, in Euro-currency banking and by Lloyds of London, respectively. It has been due to the fact that only commercial and technical feasibility determined their introduction. Regulatory processes could not prevent or even delay them. The well-known past innovations in the free banking and insurance zones are likely to

be followed by more and free zones in other industries. This should result in similar acceleration of innovation.

External diseconomies

There exist two competing theories of the reasons for regulation. The first suggests that it is the outcome of democratic political processes which enable special interest groups to enrich themselves at the expense of the general public and overall total welfare (Wolf, 1979; Cairns, 1980). To the extent that free economic zones lower trade barriers under this model, they injure only special interest groups and increase overall welfare. Therefore, the estimates of welfare gains due to free trade zones must be revised upward in a way that can never be rigorous.

Under the second model, what I have called the naive view, protection is imposed to eliminate some market failure. Lowering of trade barriers through free economic zones thus leads to the reappearance of external diseconomies and a social cost that has to be included in the welfare analysis presented above.

The impact of the external diseconomies can logically consist of the following extremes. First, the external diseconomies are confined to the host country. This might happen if through lowered protection of an import-competing industry, the country loses the security benefits of domestic agriculture or of a defense industry. Under these conditions the welfare calculus for the host country has to be adjusted downward. The calculus for the rest of the world requires no adjustment.

Impoverish my neighbor?

Second, the external diseconomies accrue mainly to the world as a whole and only minimally to the host country. For example, Euro-currency banking is feared to have raised the probability of a major global financial crisis because in the absence of national regulatory controls, these banks have invested imprudently large amounts relative to their capital base to individual borrowers of doubtful ability to repay (Grubel, 1979). Whatever may be the merit of this argument in practice, it serves to illustrate how deregulation of bank-

ing in Euro-currency markets can result in negative externalities for the world while most of the benefits from the deregulation accrue to the few financial centres hosting the Euro-currency banks. In such cases the welfare calculus of the effect of free economic zones must be amended in obvious ways that are not pursued here.

Finally, it should be noted that if the methods used for discriminating between regulated and unregulated sectors are working imperfectly, business which should be regulated escapes into the deregulated sector. For example, it may not be possible to exclude people from free gambling zones who through excessive losses become public burdens. Firms with imperfect knowledge may be included to do business with deregulated banks and insurance companies that is not in their long-run interest and leads to social losses. The negative external effects of such imperfect separation of regulated and unregulated markets must be entered into the social welfare calculus of free economic zones.

Tax revenue effects

Free economic zones cause a redistribution of tax revenue between government jurisdictions. This permits some to lower taxes and requires others to raise them (or change expenditures without corresponding changes in taxation). The resultant welfare effects are well known from the public finance literature and will not be pursued here. Instead, the following is limited to a brief taxonomy of the major tax revenue effects.

The local government jurisdiction hosting the free economic zone gains income directly if it is the landlord of the zone and raises charges to land users upon establishment of the income zone. If the owner of the land wishes to maximize his income, he will charge for the use of it an amount that is analytically equivalent to the economic rent which accrues to the occupant. A duty-free camera retail store at an airport, for example, faces a downward sloping demand curve. It sets an output level and accompanying price where marginal revenue equals marginal costs, with all inputs available at constant prices from the regulated sector and the rent being determined as a residual. In this extreme case, all of the benefits from deregulation accrue to the airport

authority and the local government owning it. Capital, managers and labour of the store are paid only their opportunity cost in the regulated sector.

If landlords charge rent above the monopolistic optimum, the level of business done in the tax free store will also be less than optimum. I have noted that in some countries duty-free airport stores charge prices that appear to be above the optimum and therefore appear to transact very little business. The question arises whether in these cases the stores exploit a very inelastic demand curve, the determinants of which may not be obvious to the casual visitor, or whether landlords have set rents too high in ignorance of the elasticity of demand.

On the other hand, it is also possible for landlords to charge less than the optimum amount. In this case the entrepreneur leasing the store enjoys economic rents, which may imply non-desirable income distribution effects. To avoid non-optimal outcomes, the owners of land on which free economic zones are established should set charges through competitive bidding.

Different governmental reactions

If the local government has an income tax, revenue is raised by the growth in factor incomes accompanying the free economic zone trade expansion. As well, the revenue is enhanced because the tax base is broadened through the migration of capital into the zone from the host country and abroad. Overall increased activity and wealth raise excise and property tax revenues of the local jurisdiction.

The senior government of the country hosting the zone suffers a loss of tariff and other revenue generated by regulation equal to that avoided by firms locating in the free economic zone. In addition, there is a shrinking in the income tax base as factor incomes are lowered in industries which contract because of lower protection. Offsetting these losses are higher factor incomes and therefore income tax revenue from export industries and the broader tax base created by the flow of foreign capital into the zone. The rest of the world loses tax base through the outflow of capital.

The most important conclusion emerging from this brief overview is that the local government hosting the zone

always gains tax revenue. It should therefore not be surprising that local governments typically are prime promoters of free economic zones. Senior governments, on the other hand, are likely to lose revenue unless the trade expansion and foreign capital inflows are large enough to offset the losses. This may well be one important reason why some senior governments, such as that of Canada, oppose the creation of free trade and economic zones.

Free Economic Zones for Other Industries?

After the analysis of the nature and welfare effects of free economic zones, it may be useful to consider application of the principles developed to other industries which are known to suffer from heavy regulation. I will do so here for the investment and drug-medical industries.

Paternalism in the regulation of capital markets of the world is very strong. It has moved from an initial concern with the accuracy of information disclosed about investment projects to where some governments have taken it upon themselves to evaluate the economic merit and risk of projects. Inevitably, the legislative requirement to have all capital issues approved by the bureaucracy has resulted in additional costs and delays. This, in effect, requires government officials to do things for which they are not particularly well qualified. Doubts have been expressed that these costs are worth the benefits to investors (Kalymon, 1978).

As in the case of insurance and banking, there is room for disagreement over the net social benefits of regulating capital markets. There exist, moreover, powerful interest groups benefiting from the regulation. Complete deregulation is therefore unlikely. It may be worth considering instead partial deregulation through the establishment of free investment zones. In such zones borrowers would not be required to obtain government approval of prospectuses accompanying the issue of new securities. Investors' protection would consist of the remaining applicability of laws which make it a criminal offense to misrepresent facts in prospectuses. Basically, however, investors would be required to have their decisions guided by the principle of "caveat emptor." This would induce them to study prospectuses carefully, using the services of private firms spe-

cializing in such evaluations, or both. And, of course, they always have the option of not buying securities in the zone at all.

It may well be that in equilibrium there would be dual capital markets. Risk averse and untrained investors would purchase securities in regulated markets and would be willing to pay the premium and accept delays involved. Firms in relatively stable industries, such as utilities, might find the costs and delays in getting approval acceptable and would be the main suppliers of securities in these regulated markets. In the unregulated zones, on the other hand, securities would be sold to investors with a preference for risky but potentially high return securities and with special skills in evaluating investments. Small and newly created firms in industries where new investment opportunities tend to develop quickly, such as high-technology and resource development, would supply securities and gain greatly in their ability to exploit new opportunities quickly and cheaply.

Free medical zones

It is well known that the regulation of drugs, hospitals, and medical doctors has resulted in excess costs because the political and bureaucratic incentive structure puts too much weight on the prevention of problems with new products and treatments, relative to the cost incurred by delays or cancellations in the introduction of new products and treatments. Studies by Grabowski (1976) and Wardell (1979) indicate that the U.S. cost of obtaining permission to market a new drug was \$50 million on average in the middle 1970s and involved testing over several years. As a result, life-saving drugs that had been proven effective and safe in Europe have become available in North America only after several years and after much unnecessary suffering and death. Some so-called “orphan drugs” are never marketed because expected sales levels would not permit the recovery of the required \$50 million investment in obtaining government approval, even though, by all medical standards such drugs are effective and safe.

There exist, in fact, free drug and hospital zones in Mexico, some Eastern European countries and in the Swiss Canton of Appenzell which is the home of many clinics using “natural” treatment methods for many ailments. Medical doctors can practice and use their titles obtained abroad without having to pass examinations required in other Swiss cantons. According to casual observations by Swiss economists, the Canton of Appenzell has attracted many patients from abroad for a long time, and business has not been impeded by expensive law-suits or scandals. Because public health-insurance programs in most countries do not cover treatment in such zones abroad, access has been limited to wealthy persons.

Drug freedom

The creation of free medical zones in industrial countries would be defensive in the sense defined above, and could be achieved simply by setting aside areas within which most of the existing regulation of drugs, treatments, and doctors are inapplicable. Patients who consider use of the facilities in the zones would have to rely on their own judgement and that of their doctors and relatives as to merit of the risks and potential benefits offered. They would have also as protection the desire of firms in the zone to continue in business. This would prevent them from offering drugs and treatments that are ineffective or carry excessive risk. Perhaps it would be useful to require that all consultations between firms in the zone and patients be recorded on video tape as evidence that patients had been given full explanations of risks, benefits, and costs and had consented to treatment under free will and in possession of their faculties.

It is clear from the preceding considerations that free investment and medical zones do not offer an opportunity for the separation of markets in the same way as do the free banking and insurance zones. In these latter types of zones, use is easily restricted to customers who through their size and other characteristics clearly have very little need for the paternalism of the state. In the case of free investment and medical zones, it is not possible to use objective criteria to limit access to those who obviously do not need protection. In the case of the medical zone, in fact, arguments can be

made that potential users are in special need of state paternalism. For these reasons perhaps the suggested creation of free investment and medical zones has little chance of being implemented in the near future.

However, in principle, the case for free investment and medical zones is much like that for free gambling zones. There may well come a time when, as in the case of gambling, the costs of regulation become so great that relatively small and politically independent areas will encourage the creation of such free investment and medical zones because of the large local benefits they promise.

Summary and Conclusions

In this chapter I have described several recent and diverse institutional innovations which permit the selective deregulation of economic activity by location or type of customer or both. It was shown that such selective deregulation, referred to conveniently as the creation of free economic zones, generates powerful interest groups which can succeed politically where attempts at complete deregulation are stalled because of some doubts about the merit of the action, and because vested interests oppose it politically.

The welfare effects of the free economic zones are theoretically indeterminate. There are gains from the expansion of trade, encouragement of innovation, and increased freedom of choice for producers and consumers. Welfare losses may arise from the locational diversion of trade and externalities, including some due to the imperfect separation of regulated and deregulated sectors. Some free economic zones created in New York are defensive in the sense that they are in response to zones created abroad and to the accompanying diversion of trade. Such zones are likely to reduce rather than increase the cost of locational diversion of trade.

If the already existing free economic zones are successful commercially and costs in terms of locational diversion and externalities are small, further free economic zones are certain to be created and new industries included. The selective deregulation of the investment and medical industries may be primary candidates for such new initiatives.

CHAPTER 4

FREE TRADE ZONES

The purpose of this chapter is to analyze more deeply the nature of free trade zones and compare them with bonded warehouses, free ports, and retail zones. Also, the advantages accruing to business from establishment in free trade zones are considered in greater detail and by focusing more on the practical aspects of relevance to business firms. This is in contrast with the focus on economics in the preceding chapter. In the section of this chapter entitled, “Advantage to Business,” the history of free trade zones is presented, concentrating on their recent growth worldwide and on the fact that Canada is one of the few countries in the world in which there are no free trade zones at all. The sections entitled, “Free Trade Zones in the Past and Present” and “Free Trade Zones in Canada,” review the history of free trade zone legislation in Canada and the government’s arguments in opposition to past legislative initiatives. The chapter closes with a proposal for the establishment of free trade zones in Canada and summarizes the arguments in favour of doing so.

The Nature and Advantages of Free Trade Zones

There exist several other institutions like free trade zones which facilitate international trade by setting aside an area subject to special treatment under laws regulating international trade. These institutions are bonded warehouses, free retail zones, and free ports. All of these trade facilitating institutions relax customs laws by different degrees and in order to achieve different objectives. Free trade zones, the most general type, provide the greatest degree of liberalization.

Bonded warehouses

These are facilities existing at points of entry in most countries, where shippers store goods between the time of arrival from abroad and customs clearance and removal by importers. The warehouses are privately owned and operated by transportation firms. They represent the most efficient solution to the problem customs authorities would otherwise face in storing and providing access to foreign goods after their arrival and before the payment of duty, clearance and pickup. They are in no way designed to “free” trade. They do not permit importers to avoid tariffs, quotas or any other regulations. Therefore, customs forms must be filled out and filed when goods enter and leave bonded warehouses. Goods are storable only for limited time periods and can be cleaned, packaged, sorted, labeled, repaired or destroyed only after specific approval by customs authorities. There can be no manufacturing activities in bonded warehouses. Basically, goods in bonded warehouses are always under customs jurisdiction, which implies limited access to and handling of goods.

Free retail zones

These facilities are found in airports, harbors and at certain road border crossings. They cater to travellers in the process of leaving the host country, usually offering for sale goods subject to high duty and excise taxes in tourists’ home countries, such as alcoholic beverages, tobacco products, and toiletries. Some free retail zones also sell duty and excise tax free manufactures that are a local speciality or have a high value relative to bulk and weight, such as photographic and electronic consumer goods. The economic significance of free retail zones is not great in industrial countries, but they provide an important source of income in some tourist-based economies, such as those of the Caribbean islands, and revenue to help finance the public ports or airports.

Free ports

These facilities historically have served what used to be known as *entrepôt* trade. Free ports usually do not permit manufacturing or assembly type operations. Rather, they concentrate on wholesale distribution and accompanying

activities such as sorting, packaging, and drying. While entrepôt trade was economically important for Hong Kong and Singapore, it has never given rise to much value-added in the absolute sense, and has been overshadowed by the growth of manufacturing in these cities. However, in recent years, the non-manufacturing activities of free ports have taken on an increasing importance in facilitating international trade generally, and in reducing trade barriers in such places as New York, Copenhagen, Helsinki, and Vienna. Importers use free ports in such places to sort merchandise and discard substandard products on which import duty is therefore saved, to store goods until import is permitted entry under quota legislation, and to exhibit machinery and products to potential customers before sale and to derive other such advantages.

Free trade or export processing zones

These facilities permit activities characterizing free ports but in addition permit manufacturing, such as petroleum refining, the assembly of automobiles, watches and electronic equipment, and the production of textiles. Free trade zones have been historically of great economic significance for the regions and even countries hosting them. They have become increasingly more important in recent years. Such zones may be quite small and occupy only the corner of a harbor or consist of a refinery; or they may be large and encompass entire cities such as Hong Kong and Singapore and include a wide range of industrial activities. A significant recent development in the United States has been the creation of free trade zones to accommodate the assembly plants of foreign automobile manufacturers, such as the VW plant in New Stanton, Pennsylvania.

The preceding definitions of different types of free trade zones are not established firmly in published writings. In practice, zones may give rise to different combinations of activities than those noted. However, the preceding definitions should be adequate in conveying the nature and flexibility of trade facilitating zones generally. Unless specified otherwise, the following analysis uses the term free trade zones to refer to those permitting the maximum amount of manufacture, processing, and other activities with minimum regulation and taxation.

Advantages to Business

From this general description of free trade zones, it is quite obvious what advantages they provide to business operating in them generally. However, it may be useful to spell out the benefits more clearly and in the tradition of journals and business manuals produced by free trade zone authorities to entice firms to establish facilities in the zones. Thus, benefits to business arising from location in free trade zones are as follows:

1. Funds are not tied up in customs duties, excise taxes, bonds or other security while goods are held in the zone.
2. Customs formalities are avoided when goods are landed in the zones from abroad or are shipped to other countries.
3. Goods entering the zone that are subject to import quotas can be brought into the host country promptly after quotas become available.
4. Goods enter the zone off transport facilities promptly and without customs delay. This generates efficiencies in shipping, docking, loading, and unloading.
5. Goods in the zone can be processed or assembled to provide a basis for duty assessment. This can result in savings, as for example when automobile parts carry a higher rate of duty than fully assembled cars and thus embody a mandated amount of locally added value.
6. Goods can be sorted and defective units can be destroyed before becoming subject to tariffs or quotas. Often the sorting can be undertaken more reliably and at lower cost than abroad and through a firm other than the importer.
7. Goods entering the zone from the host country can immediately generate any duty and excise tax drawbacks and export incentive payments.
8. Goods stored in free trade zones can be used as collateral for loans.
9. Goods in the zone imported from abroad can be packaged and labeled under close surveillance to meet host country regulations and safety standards.

10. Goods moving into or out of the zone can be packaged to take advantage of ocean freight rates that often favour goods shipped in bulk.
11. Owners of goods in zones can easily display them to potential customers; they can monitor quality and obtain samples.
12. Goods in the zone can be stored cheaply and imported into the host country quickly when random demand requires it, or when prices have moved favourably.
13. Goods previously obtained from abroad can often be shipped to world destinations. (This may be restricted for normal goods under the host country's national policies.)
14. Goods in the zone are insured at their value excluding tariffs and excise taxes. Insurance costs are lower than if goods were insured at values including these tariffs and duties.

Tax concessions and subsidies

In industrial countries, free trade zones are normally operated by local governments. They usually do not receive large subsidies, though some may be implicit in the pricing of services and of infrastructure facilities. In developing countries, on the other hand, tax concessions and subsidies are the rule rather than the exception. For example, Sri Lanka's Free Trade Zone offers a 100 per cent exemption from all taxes: "No tax on corporate and personal income, royalties, dividends — for up to 10 years. After that, a concessionary tax period for up to 15 years" (from an advertisement placed by the Investment Promotion Division, Greater Colombo Economic Commission, P.O. Box 1768, Colombo, in *The Economist*, May 31, 1980, p. 107).

The Karachi Export Processing Zone — Pakistan provides a five year tax holiday on profits. This may be extended before income taxes are levied at 25 per cent of the normal rates in Pakistan. There are no personal income taxes payable by foreign personnel attached to firms operating in the Zone (from an information booklet produced by the Export Processing Zone Authority, Karachi, Pakistan).

The tax concessions provided by Sri Lanka and Pakistan are typical of those in nearly all free trade zones in

developing countries. They provide obvious benefits to foreign investors. It may be reasonable to assume that these are required to compensate them for extra costs and risks associated with operating in the zones, such as the lack of a skilled labour force, poor transportation facilities, and danger of expropriation. The excess of the value of concessions over the costs determines the rate at which firms establish operations in the free trade zones. In the longer run, the value of the concessions can be expected to reach an equilibrium where the zones attract firms at the rate desired and consistent with the availability of labour and overall development plans of the host countries.

Free Trade Zones in the Past and Present

Free trade zones have a long history. In antiquity the Phoenicians, Greeks, and Romans encouraged the development of international trade by offering guarantees of free passage and safety to merchants from all parts of the world using their ports in Tyre, Carthage, Piraeus, and Rome. In the 17th and 18th centuries, when Western Europe had emerged from the stagnation and economic and social rigidities of the Middle Ages, the Hanseatic League of Cities was the focal point for dynamic private trade and enterprise. In this League the major cities of Western Europe declared themselves to be “Free Merchant Cities.” They formed an interest group lobbying for the freedom of trade with the innumerable petty principalities that asserted their sovereignty by imposing barriers to trade all over Europe, but especially in what later became Germany and in the Scandinavian countries.

Free trade zones have become a major force in modern times only during the 1960s and 1970s. In 1967 the U.N. Economic and Social Council (1056th plenary meeting, August 4, 1967) adopted a resolution suggesting the use of free trade zones by developing countries as a major tool for the promotion of exports. In the United States free trade zones have been made possible through legislation passed in 1934, though by 1970 only 10 such zones were operative and they were not very successful by any standards.

There are no reliable data on the growth of free trade zones throughout the world during the 1960s and 1970s.

Since 1977 a publication service for private business by Walter and Dorothy Diamond (Matthew Bender, New York, publisher) provides a list of all free trade and tax zones in the world. This is updated regularly and describes the location and characteristics of each.

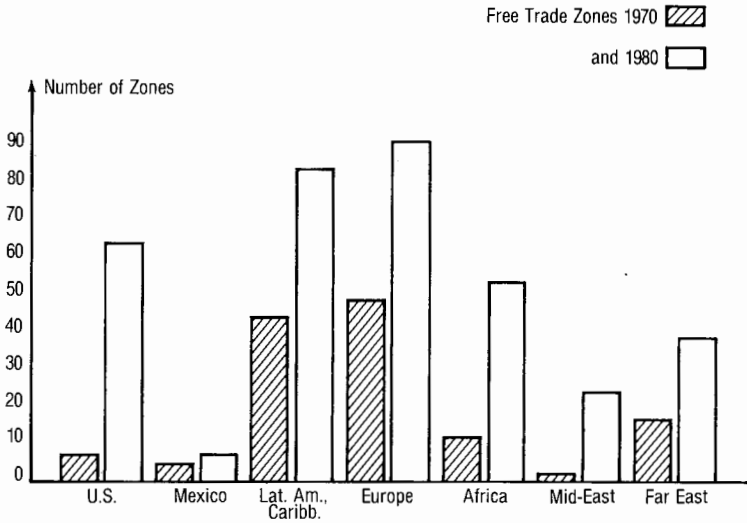


Table 4.1

Source: Walter H. and Dorothy B. Diamond, *Tax-Free Zones of the World*, New York: Matthew Bender and Co., Graphics from "The U.S. Lags in Trade Zones" *Business Week*, Nov. 17, 1980, p. 82.

Table 4.1 has been reproduced, using the information provided by the Diamond publication. It shows Europe with the largest number of free trade zones (about 90) in 1980. Latin America is second with 80, followed by the United States with 60. There are also large numbers of zones in the developing countries of Africa, the Middle East, and Far East. Mexico has about 10 zones while Canada has none.

Table 4.1 also shows clearly the dramatic growth in the number of zones during the 1970s, especially in countries and regions other than Latin America and Europe, where they were in operation in large numbers in 1970 already.

Some statistics

Data on the volume of business and employment in free trade zones are fragmentary and available only from secondary sources. *The Economist* (Nov. 22, 1980, p. 98) reports that in 1980 in the United States the 30 operating free trade zones employed 11,000 people and turned over \$4 billion, 70 per cent of which is for re-export. *Business Week* (Nov. 17, 1980, p. 82) reports, without giving a source, an estimate according to which by 1985 as much as 20 per cent of world trade will be handled through free trade zones. The United Nations Industrial Development Organization (UNIDO) in a paper "Export Processing Zones in Developing Countries," (UNIDO/ICIS. 176, August 18, 1980) reports that in 1978, employment in free trade zones in developing countries exceeded 645,000 persons and had risen to slightly less than 1 million in 1980.

Free trade zones have always been used to promote regional development and industrialization in developing countries. However, in 1981 India announced a new budget and five-year plan that gives implicit recognition to the powerful development incentives free trade zones can provide (*The Economist*, March 7, 1981, p. 73). Thus, the government of India has declared a total tax holiday for industrial units set up in free trade zones. Any plant exporting all its output qualifies automatically as a free trade zone, no matter where it is located. All the equity of such firms can be owned by foreign investors whereas foreign ownership elsewhere in India is limited to 74 per cent.

India has for many years attempted development through inward-looking policies with great reliance on government enterprise and planning. The new emphasis on foreign competition and free trade represents a significant departure. This reveals the perceived importance of free trade zones as a mechanism of dual development, permitting the retention of the planned and protected sector while taking advantage of the benefits of competition and foreign investment.

The literature

Unfortunately, there are few intensive case-studies of individual free trade zones which provide insights into rates of

growth, costs of operation, balance of payments effects, employment generated, technology transferred, and other economically relevant effects. There exist a few such studies of zones in developing countries (Naerssen 1979, Lester 1979, Jong 1976). In addition, the World Bank has evaluated several zones in the process of studying loan applications (reported in UNIDO/ICIS. 176, August 18, 1980). According to these studies, free trade zones have an overall positive economic effect on host countries. Unfortunately for the purposes of the present study, no comparable evaluations of free trade zones in industrial countries have been made.

However, unless governments act irrationally, or free trade zones only serve powerful but narrow interest groups, the rapid growth of zones documented above can serve as indirect evidence that they represent economically viable institutions for the host countries. Individual countries presumably derive benefits through the creation of trade in the wake of reduced regulation and trade diversion away from other countries. It is not clear, however, whether the creation of free trade zones is economically beneficial for the world as a whole. The question arises since national gains through trade diversion are at the expense of other countries, and the global losses due to locational inefficiencies may or may not be offset by gains in efficiency due to deregulation.

Whatever may be the outcome of studies of the global effects of free trade zones, the salient fact for Canada is that the growth of free trade zones in the world has been great in recent years and appears to be accelerating. Nations that fail to create zones of their own invite victimization through lower efficiency and loss of trade.

Free Trade Zones in Canada

The Canadian government facilitates international trade by permitting the operation of bonded warehouses at most international transportation gateways. These warehouses have long been in operation and are considered a success.

Free retail zones exist at most of Canada's international airports and major passenger marine terminals. At these locations sales tend to be limited to alcoholic beverages and tobacco products. In December 1979 the short-lived gov-

ernment under the leadership of the Progressive Conservative Prime Minister Joe Clark, announced a program for the establishment of duty-free shops at road border crossing points. The program did not move beyond the establishment of an advisory committee. This was to report to Revenue Minister Walter Baker on ways of selecting operators for the new shops and setting operating procedures and conditions.

Canada allowed free ports at Gaspé and Sault Ste. Marie during the period 1861-64. They were closed when it proved impossible to guard them against smuggling. Since then the Canadian Customs Act has prohibited the establishment of both free ports and free trade zones. However, this did not prevent periodic initiatives to obtain changes in the legislation. Applications for free ports or trade zones were filed as follows: Vancouver 1908 and 1920, Montreal 1920 and 1930, Charlottetown 1923, Halifax 1929 and 1977, Niagara District-Chippewa 1943, Quebec City 1945, Mortier Bay, Nfld. 1955.

Permission denied

All these applications were denied or lapsed. The reasons given for denial by the government of Canada were varied. But they centred on the judgement that the benefits in the form of increased trade volume would be too small in relation to the expected administration costs of operating the zones. Furthermore, it was argued that the existing system of bonded warehouses and drawbacks achieved essentially the same objectives as free trade zones. But it did so at lower administrative costs without requiring firms to relocate.

This last advantage of the drawback system is economically very important. In the analytical framework developed above, it can be described as preventing the costs of trade diversion. In effect, the drawback system permits every firm to be its own free trade zone. Canadian customs officials claim that the system of “inward processing” permits most, if not all, of the benefits of free trade zones without the need for the establishment of such zones. (This was reported in a letter by G.S. Maclaren, Manager of Cargo Development Action Mirabel published by *The Gazette* of Montreal, and written in response to a report that Canadian

firms were moving to U.S. free trade zones.) One important aspect of the Canadian drawback system is that since a 1980 order in Cabinet, firms can avoid even the temporary payment of import duty on goods destined for reexport if they can persuade customs officials of the merit of their case.

But interest persists

These official arguments have been insufficient to prevent several demands for legislative changes permitting the establishment of free trade and export processing zones. Thus, in January 1980, Quebec's Social Credit leader Fabien Roy suggested the creation of a free trade zone around Mirabel International Airport. Montreal's Mayor, Jean Drapeau, has "repeatedly mentioned" the idea of establishing a free trade zone in his city (*Vancouver Sun*, January 15, 1980, "Duty-free Mirabel urged"). In a speech to the Canadian Importers Association meeting in Toronto on April 23, 1980, Sinclair Stevens, the Progressive Conservative Treasury Board spokesman, suggested that the government of Canada explore the idea of free trade zones in Canada.

As well, several economists and officials in the Ministry of Finance under Prime Minister Clark have engaged in a feasibility study of free trade zones. The topic has also been taken up in many economic development offices of local jurisdictions and ministries of provinces. The topic is one of great interest at almost all professional meetings of Canadian managers of regional development programs.

To the best of my knowledge, the business community has not made a concerted effort to generate political pressures for legislation permitting the establishment of free trade zones in Canada. According to a report in (*The Gazette* of Montreal of June 18, 1980, "Mitel moves into duty-free trade zone,") the Montreal business community heartily endorses the idea for Canadian free trade zones put forward in 1979 by Pierre Laurin, the director of Ecole des Hautes Etudes Commerciales of the University of Montreal. However, there appears to have been no action beyond endorsement of the idea.

An Evaluation of Canadian Conditions

I will not analyze here in detail the merit of the Canadian program of bonded warehouses, free retail zones and drawbacks. Whatever its past merits may have been, in recent years three important developments have greatly strengthened the case for the establishment of free trade and export processing zones.

First, as was shown above, the rest of the world and especially the United States have in recent years opened large numbers of free trade and export processing zones. As a result, there is little doubt that existing Canadian industry is actively diverted to these foreign locations. In the longer run more important firms that would have located in Canada set up business in foreign free trade zones abroad. In a sense, the need for Canadian free trade zones is a matter of self-defense. The national interest requires this and it is necessitated by developments abroad.

Second, repeated rounds of multilateral tariff negotiations have resulted in a dramatic lowering of tariff rates in all industrial countries, including Canada. This implies that the advantages provided by free trade zones accrue less and less through the savings of duty and more and more through the savings in administrative costs and through the host of other advantages noted above. For this reason, the system of drawbacks employed in Canada, however generous it may be, is worth decreasingly less to firms manufacturing for export. By its very nature the system cannot get rid of the competitive disadvantage Canadian producers have in world markets as a result of the high cost of meeting administrative customs requirements. It also prevents Canadian producers from having the other cost-saving benefits of operating in a free trade zone noted above.

Third, Canadian economic development in recent years has led to the growth of an important high technology industry which for survival depends on large scale production and world-wide sales. Technologically intensive operations function in a fiercely competitive world market. Their success and future growth may well be hampered by the relative competitive disadvantages they suffer through the inability to locate in free trade zones as do their competitors abroad. Free trade zones in Canada were needed less when Cana-

dian exports consisted mainly of raw materials and agricultural products. Now that high technology manufactures are becoming increasingly important, free trade zones have taken on heightened importance.

In sum, the preceding analysis suggests strongly the need for the Canadian government to reexamine its traditional opposition to the establishment of free trade and export processing zones and for an alliance of business firms and regional development agencies to lobby with the provincial and federal governments for a change in existing legislation.

CHAPTER 5

FREE ENTERPRISE ZONES

This chapter is devoted to a brief review of recent insights into the causes of stagnation and decay in urban economies, which provide the intellectual justification for legislation aimed at the establishment of free enterprise zones in Britain and the United States. In the section entitled, “British and U.S. Legislation,” the essential features of this legislation are presented and serve as a basis for proposals to establish such zones in Canada discussed in the section entitled, “A Proposal for Canada.”

The Problem of Urban Decay

Research in the causes of urban unemployment and decay in the United States and Britain has focused on the two interrelated problems. First, government regulation and control have reduced incentives for the growth of small business. Second, rent control, together with poorly conceived and executed public housing programs, have resulted in slums and housing shortages.

Research on small business has shown that this form of enterprise usually represents the economic backbone of large urban centres, and provides the bulk of employment in retail stores, service shops and small manufacturing. Only a surprisingly small proportion of a typical area’s workforce is employed in large downtown office buildings and in factories in industrial zones. Owning and operating a small urban business has always been relatively easy because of low capital and skill requirements. However, small business failures have also been high traditionally, as firms suffered from inadequate capitalization, poor managerial abilities, or both. Moreover, successful small firms often found it necessary to move out of the urban core to obtain space for increased production. In the past, these business failures

and departures from the core of cities did not matter since new entrepreneurs were always forthcoming at a pace sufficient to replace those that had failed or moved out.

In recent years, however, there has been a pronounced slowdown in the rate at which new entrepreneurs have come forward. As a result, employment opportunities in urban centres were reduced, and unemployment and poverty increased. This led to increased crime rates, dependence on welfare and rent controls. What were the causes of this reduced supply of entrepreneurs?

Lack of entrepreneurship

One important set of factors has been government regulations, taxes, controls, and welfare programs. Especially raising the operating costs of small firms were minimum wage legislation, employment taxes for unemployment insurance and health care, and the enforcement of new, high standard health and safety legislation. In addition, the financing of local welfare programs required higher property and business taxes. Inflation combined with high marginal personal tax rates reduced net returns from being successful. Increased crime raised insurance rates for business. Welfare programs reduced incentives for steady employment and increasing unionization made it more difficult to discipline and fire workers.

While business firms outside the core of large cities were subject to many of the same disincentives, the traditionally low productivity and simple technology of the small business firms in the urban centres made them less able to adjust to these changes. Their competitors in suburban shopping centres and industrial parks escaped relatively unscathed, for operating scales were larger there, and this permitted the introduction of more labour saving devices.

Government programs designed to help small business firms in urban centres did not succeed. This was partly because the disincentives created by other programs were too large. As well, small business success by its very nature is very difficult to predict. Thus government programs cannot readily identify for support individual entrepreneurs likely to succeed from among large numbers of candidates.

Housing problems

High levels of welfare programs in large cities relative to those available in small towns and rural areas attracted poorly trained immigrants. The ranks of those poor were swelled by those unemployed as a result of minimum work legislation, and the shrinking of the small business. Unemployment and welfare payments tended to lag behind rapid inflation rates. As a result, housing costs as a proportion of income of the poor increased. This led to demands for rent controls and for public housing.

But rent controls decreased the supply of housing and this worsened the conditions of the poor. Any legislation that succeeds in lowering the price of a good or service must reduce supplies, increase demand and therefore produce shortages.

The government's answer was to build publicly financed housing and rent it out at subsidized rates. To build inexpensively and efficiently, public housing projects were built high rise style and located in areas where land was cheap. Such land was available because small business had moved out, private single family home-ownership had ended and rent controls had delapidated or destroyed privately owned apartment buildings.

Even so, these housing projects by and large have been expensive failures. Since poverty was a criterion for eligibility, this led to a great concentration of poor families. For a variety of sociological reasons, this encouraged hooliganism, crime, and general slum conditions. Many of these public housing projects in the United States and Britain have been abandoned and the buildings have been razed. Since then, governments have moved increasingly towards the payment of rent subsidies for the poor and towards the creation of selected incentives for the private renovation and renewal of old housing.

In spite of these policies of aid to urban centres, many remain in a depressed state. In others, conditions continue to worsen. This is because the fundamental causes of the problem, decreased incentives for small business, and rent controls, have not been changed. Many experts believe that the solution requires more fundamental changes in government policies than have been undertaken thus far.

British and U.S. Legislation

Based on this diagnosis, in 1977 Professor Peter Hall, an urban planning expert at the University of Reading in England, proposed what later became known as free enterprise zones. In its original form the proposal envisaged “an essay in non-plan...for the encouragement of entrepreneurship and capital...the areas would be based on fairly shameless free enterprise and free of taxes, social services, industrial and other regulations...residents would be free to leave or to stay under the new system of deregulation, low taxation and low social benefits.”

Professor Hall’s idea was picked up by the then conservative opposition spokesman on economics in the British Parliament, Sir Geoffrey Howe, who later became the Chancellor of the Exchequer under Prime Minister Margaret Thatcher. In a speech in 1978 he outlined a plan that represents essentially a modification of Hall’s proposals and which served as the foundation of measures announced in the budget speech of March 26, 1980. According to this plan the Secretary of State for the Environment consults with local authorities in three or four areas in England and one each in Scotland, Wales, and Northern Ireland to determine the boundary of areas to be designated as enterprise zones. Within these zones, comprising up to 500 acres, private enterprise will be positively encouraged by reducing the burden of government supervision and fiscal demands. The sites chosen will be in areas of physical and economic decay where conventional government policies have not been successful.

The specifics

More specifically, both new and existing firms in the U.K. enterprise zones will benefit from the following measures:

1. Exemption from the development land tax.
2. One hundred per cent allowances for income and corporation tax purposes of expenditures on industrial and commercial property.
3. Exemption from local property taxes, with provision for reimbursement of local authorities by the central government.
4. Simplification of planning procedures, guided by a plan

of what is permitted so that developers conforming to these conditions do not require permits.

5. Exemptions from the payment of levies for the training of labour.
6. Speedier handling of requests for customs warehousing and inward processing of imported inputs.
7. Abolition of remaining industrial development certificates.
8. Reduction to a bare minimum of government requests for statistical information.

In the announcement of these measures it was noted explicitly that in the zones there would be no reduction in standards needed to protect health and safety or to control pollution.

U.S. proposals

The idea for the establishment of enterprise zones in the United States was first advanced in a publication by Stuart Butler for The Heritage Foundation, a conservative think tank in Washington. In it, the basic ideas of the British concept were set out for discussion and three important new ideas were introduced: the suspension of minimum wage laws; the establishment of a turn-over trigger point system which would limit the availability of tax exemption by time, volume of business, or both, in order to prevent the zones from becoming havens for tax avoidance; and the incorporation of genuine free trade zone features of the sort discussed in Chapter 4. To encourage the development of private housing in designated areas the proposal envisaged the abandonment of rent controls. An increase in rent supplement programs for low-income earners, no charges for development land abandoned by former owners, and simplification of zoning and building regulations for commercial property. Basically, the author envisaged the enterprise zones to be arenas for experimentation with economic and social policies, such as the negative income tax or a youth minimum wage law.

A 1979 bill in the Illinois legislature proposed the establishment of enterprise zones according to the British model. However, the nature of the proposed deregulation was limited by the fact that the state can relax or remove only

regulations, laws, and taxes it had imposed itself. Therefore it could not tamper with federal regulations. The bill narrowly failed to become law as it did not receive the three-fifths majority vote required in the state's senate. It is believed that the defeat was due to strong opposition to the bill by the City Council of Chicago.

In the U.S. Congress, Representative Jack Kemp of New York, presented a proposal for Enterprise Zone legislation in May 1980 (H.R. 7240) and a second bill in June 1980 (H.R. 7563), which was co-sponsored by Democrat Robert Garcia of the South Bronx. The Kemp-Garcia bill, known as the Urban Jobs and Enterprise Zone Act, received much support and was discussed widely among politicians and intellectuals.

In his January 1983 State of the Union Message President Reagan announced his administration's proposals for enterprise zone legislation. The federal government will grant special tax credits to spur investment and job creation in designated areas. However, these credits will become available only to areas where local governments simultaneously reduce property taxes and deregulate zoning, building, and environmental requirements. Municipalities have for some time been lobbying for such legislation in Washington and made representations to increase their chance to be selected for demonstration projects.

A Proposal for Canada

So far there have been no proposals for the establishment of enterprise zones in Canada.* One reason for this fact may be the relative prosperity of Canadian cities. Yet, there are many depressed areas and cities in the Maritime provinces, Quebec and Ontario, that could be revived by the creation of free enterprise zones.

In addition, free enterprise zones could serve another objective of Canadian policy, the creation of a modern industrial sector consisting of high technology firms. In industries such as electronics, pharmaceuticals, computers and aero-space, technology and product design change

* While there have been no proposals for enterprise zones, there have been proposals made for free ports and trade zones, a related although distinct concept. See above page 68 — ed.

quickly and freedom from regulatory requirements is important to compete successfully in the international market place. In addition, innovative methods for risk sharing in such industries would aid their international competitiveness. For example, employees would accept currently lower wages in expectation of larger, compensatory gains in the future when the firm is successful. Such an arrangement might violate minimum wage legislation and other rules but would be legal in free enterprise zones.

Free enterprise zones with the features found in the British and U.S. proposals might well be suitable and effective for dealing with the problems of stagnation and decay in areas of Eastern and Central Canada. As in Britain and the United States, existing populations strongly limit the amount of politically feasible deregulation, since it is likely to encroach on established privileges and interests. For this reason, I propose the establishment of Canadian Enterprise Zones in urban settings with the following characteristics:

1. Low or zero property taxes.
2. Accelerated depreciation on investment.
3. Simplified procedures for obtaining local authority planning permits and for reporting to statistical and other government authorities.
4. The granting of free trade zone status.

Limitations on the tax and depreciation concessions to individual firms might have to be introduced to prevent the zones from becoming tax-havens for large corporations. If allowed, this would render the zones instruments of pure trade diversion with only small trade creation effects.

Industrial parks

However, in order to encourage the development of new, high-technology industries, it may be useful to consider the establishment of free enterprise zones on undeveloped land near urban centres. Here, existing interests would be less likely to be damaged and thus to offer resistance to more dramatic forms of deregulation. These high technology free enterprise zones are proposed in addition to those noted above, and entail the following:

1. Suspension of minimum wage legislation
2. Abandonment of compulsory employer and employee contributions to:

- a) Unemployment Insurance Program
 - b) Canada Pension Plan
 - c) Public Medical Insurance
3. Prohibition of closed shops.

Points two and three will reduce union power. They are likely to meet opposition from people who fear worker exploitation and a loss of important insurance benefits. However, neither of these are likely to occur. Employers will have to compete for workers with those in the regulated sectors of the economy. Therefore, they will have to compensate employees for the loss of public insurance benefits by some combination of paying higher wages, offering private health and retirement insurance, and retaining voluntary membership in public insurance schemes. Workers will be attracted to the free enterprise zones only if the package of wages and benefits is at least as good as the one offered in the regulated sector of the economy. Therefore, by voting with their feet, they will demonstrate they are not being exploited. To the contrary, by choosing to work in the zone, they indicate that they are better off with the package offered there than the one available in the rest of the economy.

More options

This improvement in welfare would be brought about by the opportunity to make personal choices that the paternalistic and compulsory public system now prevents. For example, a young, healthy, bright, and energetic worker may rationally prefer a higher present cash income to greater future security. He may use self-insurance against unemployment, illness, and retirement rather than accept the government program. Such a worker might choose this option because he can purchase a low-premium health-insurance policy offering protection against catastrophic illnesses. He may prefer to run the risk of paying for minor illnesses. This individual also may decide that the chances of unemployment are so low that a small savings account would provide adequate protection. He may expect to invest for his own retirement more effectively than government.

The individual may prefer the dynamism and growth potential of a non-unionized firm or one with a union whose

power is weakened by the absence of a closed shop provision. These are all matters of private preferences. If most people prefer the standard package offered in the regulated sector, then the free enterprise zones will fail. Alternatively the employers will be forced to disregard any or all of the special legal dispensations they have been granted in order to attract the quantity and quality of workers they want and need.

Benefits for firms

The firms operating under the proposed conditions in these zones benefit from greater flexibility and freedom in running their business. For example, a firm in a new, high-risk business may offer its employees very low starting wages but participation in future profits to workers. Initial low production costs might overcome the competitive disadvantage in world markets stemming from the inexperience of both workers and management. There are innumerable examples in the history of modern industry where pioneers accepted voluntarily initial lower returns, hard work, and high risk and were rewarded later by high profits and wages. In fact many such industries could not have started without the initial investment in frugality and extra effort.

Average labour costs of producers should also fall as workers are attracted by desirable features of the package of wages and other benefits offered. They may be willing to accept this even though the total monetary value may be less than the one offered in the regulated sector with an unalterable combination of more and less desirable features.

In sum, the firms in the zones are likely to benefit through lower operating costs and greater flexibility in employment contracts. This may well provide the needed stimulus for setting up of production facilities and the design and marketing of products that otherwise would be lost for Canada. As a result Canadian industry can be expected to be more competitive in international trade and in domestic competition with foreign imports. The resultant increased economic level of output and productivity is the trade expansion, which is beneficial for people living in the local jurisdictions hosting the zones as well as for Canada as a whole and the rest of the world.

Free housing construction zones

Canada has been plagued by the heavy hand of housing regulation and planning. In order to counter this trend I propose the establishment of free housing construction zones on large parcels of undeveloped land near urban centres or enterprise zones that are located away from existing centres.

The free housing construction zones would be created by the government offering for sale in auctions, parcels of land large enough to accommodate viable communities. We would initiate such a program with property that is undeveloped, perhaps because of surface characteristics which normally make it non-economic, such as mountains or marshes. Or perhaps land of marginal use for agriculture or forestry may be converted to this use.

Entrepreneurs bidding for development of these zones would be free from all regulations concerning community planning, population density, zoning and construction quality. By appropriate, legally binding means the government would assure potential investors that rent controls will never be applied to housing in these zones.

As in the case of all of the other forms of deregulation discussed in this study, the absence of government regulation and control of housing standards does not mean that consumers would necessarily be subjected to dangerous and uncomfortable conditions. On the one hand, they don't have to purchase the products marketed by the developers. On the other hand, the desire to sell the housing in these zones at a maximum profit would tend to assure that entrepreneurs build structures with quality and other characteristics that consumers find attractive. Independent, privately owned rating firms, such as a "Consumers Report on Housing" could furnish information on housing quality on a competitive basis.

Low quality and dangerous construction reduce the price that can be charged in the entire zone. High density leads to more housing units, but also lowers the price per unit. The provision of public conveniences and necessities such as shopping, recreation, and municipal service centres increase the prices obtainable from residential properties. All of the myriad trade-offs between price, quality, and con-

venience will be made by entrepreneurs with a most powerful desire to please consumers, unfettered by controls and regulations that may be irrelevant or only serve narrow interest groups in established communities.

Economic rent

The sale of the land for development through public auction assures that the governmental jurisdiction owning the land originally acquires all of the economic rent. This leaves developers only with normal profits. In cases where the land is mountainous or has other features that make it costly to develop, the bids for development rights will tend to be low. If development is totally non-economic, there are no bids. One of the major advantages, therefore, is that bureaucrats do not have to make judgements about the economic viability of land parcels. Instead, private entrepreneurs will apply the latest and best technology to put to human use land that otherwise has none or much inferior economic uses.

If the government succeeds in assuring investors that the free housing construction zones are protected permanently from rent control legislation, then they will attract investment in rental accommodations wherever there is demand for such facilities. It is likely that this financing would be a net gain to the region since in the assured absence of rent controls, the investors might have put their funds to other uses.

The government can assure that the new communities developed in the zones have some housing for senior citizens or any other groups of people it wishes to subsidize, without having to incur any outright expenditures. All that needs to be done is to specify that entrepreneurs bidding for the development rights have to accept the responsibility for constructing accommodation with specified characteristics to be leased or sold to the government at a set price. Any losses from the construction and revenue of such facilities, of course, would be reflected in lower bids for the development rights. The resultant lowering of government revenue represents the indirect subsidy to the social housing created by the policy.

It is conceivable that the proposed zones would attract international and Canadian consortia of architects, developers, and financiers. Such firms would welcome the opportunity to create model-communities through the use of the latest techniques in construction and planning. The development of the resort community of Whistler in British Columbia is an example of the kind of dynamism private enterprise could bring to free housing construction zones.

CHAPTER 6

FREE GAMBLING ZONES

History

Legislation prohibiting gambling in Canada originated with the 19th century puritan ethic of the early settlers. They brought with them from Europe the view that it was amoral to acquire wealth through means other than hard work. But this ethic has been eroded gradually. With it has gone the almost universal legislative ban on gambling. In the 1980s Canadians can readily and legally give in to their gambling desires. They can place bets at race-tracks and purchase lottery tickets sold by several government jurisdictions. The existence of these publicly sanctioned gambling facilities is direct evidence of the fact that Canadians in general have accepted the principle that gambling is basically no different from any other good or service. By permitting access to lotteries and race-tracks for anyone other than minors, Canadians also have accepted the principle that adults can be trusted to spend their incomes responsibly and without paternalistic prohibitions against gambling.

In Europe and the United States a similar change in public attitudes has taken place. However, governments in these areas have permitted additional forms of gambling which are still prohibited in Canada. Special gaming devices such as slot-machines, roulette and craps, and card-games like black jack and poker, are all housed in casinos where the availability of food, drink, other forms of entertainment, and the entire ambience provide a unique package of entertainment. As a result of the prohibition against the operation of such casinos, Canadians are deprived of a form of entertainment that appeals to some and forces them to travel abroad for its enjoyment.

Puritan vestiges

It is not clear why Canadian governments have maintained the prohibition against casinos. There are at least two main explanations. First, it may be that Canadians on average retain enough of the puritan ethic to make it impossible to permit the operation of casinos that are, unlike the race-track and lottery sales facilities, establishments deliberately designed to appeal to the lustful instincts of people in very luxurious environments. Moreover, such environments create conditions where “betting fever” can lead to irrational behaviour. Second, it may be that there is a concern with what happens to the winnings of casinos.

It is morally acceptable, if not desirable, for lottery profits to finance charities and other publicly valued functions. This suggests the public ownership of casinos as a solution. But because of the sybaristic nature of casinos, governments are reluctant to become owners and operators. Private ownership, on the other hand, has the disadvantage of leading to an undesirable use of the potentially large profits. In addition, it has a bad reputation because large undocumented cash flows permit criminals to launder funds.

These concerns are not particular to this country. They exist in Europe and the United States as well. They have determined the institutional characteristic of casino operation and ownership in these areas. It is therefore useful to consider these, because they provide insights into possible Canadian policies towards the establishment and operation of casinos.

Operation and Ownership Abroad

In most countries of Europe and in the United States, gambling casinos have been established in areas frequented by tourists. In Germany, the old and famous casinos are located in spas such as Baden Baden and Bad Homburg. The grandfather of glittering casinos, Monte Carlo, is in the heart of the French tourist mecca of the Riviera. In the United States, the gambling casinos used to be concentrated in Nevada, which at their founding in 1931 had a very small resident population. The casinos in Atlantic City created in the late 1970s were designed to revive a moribund city that

had once been a major tourist centre on the New Jersey shore.

The preceding description points to the important fact that gambling casinos are located in out-of-the way places. It is therefore possible to discriminate among users and exclude without too much trouble those who might need protection from themselves. At the time when the European spas opened their casinos and Nevada legalized gambling, tourism was not the mass phenomenon that it is today. Then, only the well-to-do, many of whom were from abroad, could afford to travel to these centres for holidays and gambling. It is easy to see how politicians can rationalize the establishment of gambling facilities. They could be expected to serve only the rich (who could afford to lose), to generate extra tax revenue (that permitted lower tax rates for local residents), and were likely to draw foreigners whose morality standards were of little concern.

Benign discrimination

To make sure that the customers of these gambling zones had desirable characteristics, other forms of discrimination were introduced. Many are in effect today. Most obviously, minors are not admitted to the gambling areas. In Germany, casinos charge an admission fee and require that gamblers are registered and identified. This registration system is used by compulsive gamblers who can instruct casino admissions offices to bar them from admission. In addition, compulsive gambling is limited by the lack of access to credit on the premises.

In 1960 gambling casinos were licensed in Britain. That country now has 123 such “clubs.” They cannot advertise and do not allow credit. They have policies to discourage local users and impulsive and compulsive gambling. These include the requirement that new members wait two days before they can use club facilities.

Visits to free gambling zones in Europe and the United States establish that gamblers consist predominantly of foreigners or well-to-do locals. There are no massive social problems. Losing gamblers do not become public burdens.

The proceeds are taxed

What of the problem of the use of casino winnings? The ownership of casinos is private, but earnings are taxed very heavily. There are special levies on each gaming device in addition to the normal corporate and local taxes. In the state of Nevada, the government revenues from the gambling industry constitute a very significant share of the total.

What of the problem of organized crime involvement? This has been solved through strict licensing requirements and government inspection of operations and gaming devices. In countries that have casinos and a gambling industry, the public has accepted, without apparent resentment, the private ownership and operation of the facilities. There have been no great scandals in recent years in the United States concerning the involvement of organized crime or the cheating of the public. Similarly in Europe, casinos enjoy a solid reputation.

It could be argued that the favourable reputation of casinos may only be the result of good public relations or clever work by criminals. It may not be possible to determine fully the validity of this point of view. However, there is a good reason for believing that casinos by and large operate honestly because of the existence of competition and the behaviour it forces on operators.

Once gambling casinos are legal and numerous, they compete for a relatively small group of customers. As well, they compete with numerous other forms of entertainment. If a casino consistently operates gaming devices with poor pay-offs, customers will patronize those that don't. If the overall package of entertainment, gambling excitement, and winnings is poor, then customers will not repeat their visits. They will spend their money elsewhere. In relevant ways, casinos and gambling are much like other industries. If they want customers, they have to deliver value. Competition, moreover, assures the absence of excessive profits.

Casinos in Canada

The preceding review of the history and current condition of the gambling industry in Europe and the United States suggests that the time has arrived for the establishment of casinos in Canada. This view is shared by Tom Alderman

(“Place Your Bets: The Casinos are Coming,” *Canadian Weekend*, December 8, 1979), who predicts confidently that casinos will be commonplace in Canada by the end of the 1980s.

As in the case of free trade zones, the final push for the establishment of free gambling zones in Canada may come as a result of developments abroad. There are several U.S. jurisdictions which are carefully watching the experience with gambling in Atlantic City. If it is favourable, then the other old resort centres that have lost their past glitter, such as Niagara Falls, will encourage similar developments. Newer and still successful resorts such as Aspen and Miami Beach will not be far behind. These developments, if successful, will lead to demands from Canadian resorts to be permitted to do the same.

According to Alderman, planning on these matters is already taking place, although politicians and government officials are reluctant to disclose this, because “the moralists still can make a lot of noise.” Thus, several provinces have already asked the federal government to pass legislation enabling them to establish casinos under their own jurisdiction without limitations as to the ownership of the facilities and the use of winnings. Since 1969, moreover, provinces have been permitted to license the operation of casinos for charitable purposes. As a result, most provinces now have such casinos. But because betting limits are one or two dollars, except in Alberta where the limit is \$25, they are not well known, nor have they developed into genuine gambling zones. Alderman reports that “Quebec is already working on the details of its first casino. And Ontario, worried that nearby New York State will soon allow casino gambling, promises to fight roulette wheel with roulette wheel.” (op. cit., p. 4).

Pragmatic considerations

Such developments have a good chance of succeeding, because they are likely to locate in resort areas frequented by tourists. As such, they would effectively permit discrimination between customers. This might satisfy the moralists who are not convinced that the average Canadian can be trusted to spend money wisely or that betting wins are

morally acceptable. The analysis of free trade zones suggests that competition among casinos will lead to expansion of trade rather than excess profits by a few license holders, or once-and-for-all windfall incomes for the jurisdictions which sell the permits.

It will not be easy to achieve competition and optimal location of a gambling industry in Canada. It would be best for the provincial legislatures to pass legislation enabling municipalities to license casinos within their borders if they decide to do so through a public referendum. Given such an authority, it is highly likely that only resort municipalities would do so. For only they can reasonably expect an increased flow of tourists whose gambling profits can easily be taxed and used to finance other recreational facilities for tourists. Consider the position of municipalities where the main economic base consists of residential housing, agriculture or industry. They would find little support from voters for the establishment of casinos that could not be expected to attract resources into the community from outside. Their creation would only represent an implicit new form of taxation of local residents.

The basic analysis of free trade zones also suggests the importance of low levels of regulation and licensing fees. Such methods of control and taxation tend to discourage enterprise and expansion. Municipalities can be expected to obtain larger revenues from the taxation of casino gambling profits than from large basic fees, and charges for development and land permits. The latter would force the casinos to charge high prices and offer relatively poor pay-offs. This would only discourage the growth of business.

CHAPTER 7

FREE MEDICAL AND DRUG ZONES

The Background

The regulation and control of the drug industry in Canada was imposed in response to the marketing of drugs which have unknown and possibly adverse consequences for their users. The drug Thalidomide, which during the 1960s caused infants to be born with severe deformities, is the best-known example of a drug which was marketed without adequate knowledge of undesirable side-effects. Economists argue that the marketing of such drugs involves a market failure. This calls for regulation and control because developers of drugs would otherwise invest socially inadequate amounts of resources in the testing of drugs before putting them on the market. In the case of Thalidomide, for example, the cost of caring for the hundreds of deformed persons has fallen largely upon society as a whole since the manufacturer does not have adequate resources. And this is to say nothing of the tragic psychic costs involved. According to this line of reasoning, market failure in the drug industry causes too many drugs to be developed because private decisions inadequately reflect the true social costs of insufficiently tested drugs.

As a result of this sort of market-failure, the Canadian government has created the Canadian Drug Commission and entrusted it with the task of setting standards for the testing of drugs. In principle, this would eliminate the marketing of drugs with undesirable side-effects. However, in an uncertain world, no known testing program can totally eliminate the development of drugs with negative side-effects. Paradoxically, it is not desirable to do so from a social and economic point of view. For example, aspirin is a

widely used drug. But it causes several deaths every year in the world as a result of allergic reactions, addiction, and overdoses by users. Yet, the benefits to the hundreds of millions of users of aspirin around the world by far outweigh the costs to the few affected adversely.

Public Choice Theory

The existing regulation of the drug industry has been criticized on the grounds that it imposes social costs which exceed the benefits. The costs of the regulation are the slower rate of introduction of new drugs, long testing periods and the higher costs resulting from the need for the more intensive testing procedure. This criticism is based on the theory of public choice. According to this new theory, bureaucrats and politicians are motivated by forces which necessarily lead to over-regulation and may, in fact, result in costs exceeding those of the market failure it was designed to eliminate.

This is so because the motivations of politicians and bureaucrats are dominated by the desire to avoid the consequences of too little regulation. In the case of the drug industry, the worst thing that can happen to a government and the regulators, is the occurrence of another Thalidomide case. But what of the people who suffer or even die because an effective drug is prohibited or becomes available after a long delay and is very costly? Their suffering carries no effective weight for the politicians and regulators. These costs are so diffuse and difficult to identify that there exists no organization interested in opposing the regulation. The politicians and regulators are hardly aware of their existence.

Biased experts

The drug industry itself is basically indifferent to the regulation since competition assures that profits are at least normal. More important, the industry's representatives can influence the regulatory authorities so that profits may even be raised above normal. This is so because regulatory agencies have to rely very heavily on the judgement of technical experts. These experts most frequently work for the regulated industry and often are the only qualified persons avail-

able for consultation. Frequently, regulators themselves are former or future employees of the regulated industry, not because they have low moral standards but because of the inevitable transfer of relevant skills and knowledge. Such regulators tend to interpret evidence in a manner which both reduces the probability of accepting drugs with side-effects and benefits the industry in disregard of the public interest. For example, we would expect decisions about permits to import drugs tested by foreign regulatory agencies to be biased in favour of being too restrictive. Such a policy bias reduces the risk of accidental side-effects and benefits the industry as well.

The cost of over-regulation

It has been said that the net result of this so-called non-market failure of the regulatory process has been a system of testing requirements which would make it impossible today to obtain permission for the marketing of aspirin and many other drugs which are accepted as socially beneficial, in spite of some problems associated with their use. It has been estimated that in the United States it costs about \$50 million to launch a new drug, even if its effectiveness and safety has been established abroad. This has given rise to the phenomenon of “orphan drugs.” These are medicines which are safe and beneficial, but for which the expected market is so small that producers cannot expect to recover the \$50 million investment in passing the government approval procedures. As a result, drug companies are forced to abandon many new and promising drugs. Canadian conditions reflect those in the United States since Canadian drug laws are modeled after those in the United States. However, the subject has not been studied carefully in the Canadian context as it has by W. Wardell in the United States.

Unfortunately, it is not possible with present tools of analysis to produce reliable estimates of the social and economic costs of over-regulation of the drug industry. This is so at least in part because such cost estimates involve judgements about the magnitude of pain and suffering of different individuals affected by different diseases. What is the value of avoiding another Thalidomide tragedy with the resultant suffering throughout life of an unknown number of

deformed human beings, as compared with the magnitude of the costs of extra hours of pain, lost work days and premature deaths of individuals who could have been helped by the earlier and lower cost marketing of many new drugs?

Here is where the power of the theory of non-market failure lies. It does not require the need for anyone to make such judgements about the value of different peoples' gains and losses from regulation. Instead, the theory concentrates on the incentive structure motivating legislatures and regulators. It implies that this must necessarily result in an underrepresentation of the costs of regulation because they are so diffuse and difficult to recognize. Thus they have no effective spokesman or lobbyists other than the occasional academic scribbler. Acting like the rational maximisers that they are, politicians and bureaucrats therefore make and administer more restrictive regulations than they would if the costs were as well known and had the same kind of political representation as do the benefits of the regulation.

Problems of medical treatment and procedures

The problems of drug regulation just discussed have a strict parallel in medical treatment and procedures, although there is one difference. Licensing of medical practitioners and treatments is undertaken by the medical profession itself, through self-regulation backed by legislation. Acupuncturists cannot practice their trade legally or become members of government-sponsored insurance schemes that pay for acupuncture treatment. In many countries, chiropractors are subject to similar discriminatory treatment.

The issues over the merits and demerits of placing such powerful licensing rights with traditional medical practitioners are obvious from the analysis presented in the context of drug regulation. On the one hand, there are social and economic benefits from the licensing of physicians and treatment procedures that assure that fraud and incompetence are minimized. In addition, they assure that patients don't have to incur the costs of investigating on their own the qualifications and skills of individual physicians. On the other hand, the medical boards have strong private incentives to protect themselves. Foremost is the desire not to be blamed for having licensed incompetent physicians and

approved ineffective or harmful treatment procedures. Unfortunately, there are no pay-offs to them from being innovative and taking risks with new medical specialties and treatments. As in the case of drug regulation, those suffering or dying from the non-availability or delay in introduction of new specialties or treatments have no voice. They cannot harm or bring much pressure on the members of medical boards. As a result, there is a decisive bias in the system of licensing physicians and treatments that leads to excessive caution and accompanying losses in welfare.

Consequences of regulation

The preceding analysis suggests that regulation of the drug and medical industry in Canada has led to the following costs to society. First, new drugs and treatment procedures are introduced into Canada with a delay which results in unnecessary suffering and deaths. Second, the cost of drugs and treatments is raised and results in an overall lower standard of living. Third, patients are deprived of some freedom of choice between drugs and treatments. Some of these may well be effective in curing or alleviating symptoms of diseases at the risk of side-effects which they find acceptable, given their tastes and circumstances. Regulation in effect determines for them the risks they are permitted to take. As a result, some Canadians are forced to travel abroad to obtain drugs and treatment unavailable domestically. Since typically only well-to-do people can afford such medical care in foreign countries, the regulation resulting in this state of affairs is in conflict with the objective of Canadian policy designed to give equal access to medical care to all people regardless of income.

Free Drug and Hospital Zones

In contrast with free trade, enterprise, and gambling zones discussed in preceding chapters, free drug and medical zones do not exist abroad in the form of explicitly designed havens of deregulation. True, there are famous clinics and spas in many countries such as Mexico, Switzerland, and some of Eastern Europe. These provide treatment and drugs for a wide variety of ailments, including the universal

ailment known as aging, which are not available in Canada. But these facilities appear more to be the outcome of historical traditions, imperfect regulatory control, or both, than of deliberate expressions of the desire to experiment and provide freedom of choice to patients.

The proposal for the establishment of free drug and hospital zones in Canada, therefore, is not based on precedent. However, the rationale for free drug and hospital zones is the same as that for the others: Canadians would benefit by having access to new drugs and treatments more quickly and at lower cost than in the regulated sector. Their protection from abuse and malpractice would be provided by competition and the self-interest of business in the zones.

Free drug and hospital zones can be established by federal and provincial legislation. This would enable private industry to set aside certain geographically defined areas within which drug companies, doctors and hospitals can dispense drugs and treatments free from the need to obtain existing regulatory approval. Potential users of the zonal facilities would be made aware of the conditions under which the facilities are operated and therefore of the risks they take by using them.

Payment for services received in these free drug and hospital zones could be made completely private. Alternatively, public health insurance schemes could reimburse patients for a certain percentage of the costs, perhaps 50 or 75 per cent.

What would it be like?

Because of the absence of precedents, it is only possible to speculate about the likely developments in the zones. For example, one might expect that private entrepreneurs, with the help perhaps of multinational drug companies, would develop in the zone facilities resembling and rivalling those now existing in several European countries and Mexico. Thus, there would likely be clinics resembling hotels more than hospitals, where doctors offer special treatments whose effectiveness may be doubted by recent graduates of medical schools, but which are sworn to be effective by many doctors and patients. This might include the use of cell and hormone therapy to retard the aging process, special

diets, baths, herbal remedies, and exercises to reduce obesity or deal with debilitating back and nervous disorders. The availability of hot springs and mineral waters and of an unpolluted environment chosen for the zones might attract therapeutical treatments drawing on these natural ingredients.

Perhaps more important, the zone might also attract specialist doctors who are kept informed regularly by drug companies about the availability of new drugs that have shown promise in dealing with cancer and other diseases, but for which there are only inferior or no alternative treatment methods available. Facilities operated by these specialists might serve as “treatments of last resort.” They might offer refuge and hope for people from around the world whose afflictions have been regarded as incurable by regular doctors. These patients, naturally, would be dissatisfied with treatments available in their regulated environments, but could afford what probably would be expensive care.

In the longer run, the free drug and hospital zone might offer a complete range of facilities and specialists, assuring patients the availability of highly expert care. It is not inconceivable that the zone could become a haven for doctors and pharmacologists eager to develop and experiment with new methods of treatment and the use of new drugs that would not be possible elsewhere.

Safeguarding the public

The basic principle of operation would be that patients can accept treatment only with the full knowledge of the risks. But if they do, they would thereby renounce their normal rights to sue doctors or institutions for any consequences of such treatments except that they be allowed to sue for gross negligence. As well, they would have to renounce their rights to receive any public assistance necessitated by possible failure of treatment. As in the case of all of the other proposed free zones, the main protection of customers would occur through disclosure requirements and the usual commercial incentives on doctors, drug companies, and hospitals who wish to retain sufficient customers to assure income and profits.

Disclosure in the case of a free medical zone would primarily take the form of notifying patients of the precise state of medical knowledge and of the risks, costs, and benefits of the proposed treatments, as well as alternatives. After having received this information, however, they would be free to choose any treatment desired.

In medical care there are many uncertainties. The consequences of all courses of treatment cannot be known, except in terms of probabilities. In addition, a full explanation of proposed care may involve very technical medical terms and concepts. As a result, some patients, especially if they are in pain or under emotional stress, may not be able to make decisions as rationally as they do when they purchase more conventional goods and services. Therefore, protection of patients depends not only on disclosure in the normal sense, but also on the ethics of doctors conveying the information. For doctors, in such circumstances, necessarily make some judgements about treatment for their patients.

Legislation is no guarantee

Unfortunately, ethical standards of behaviour by doctors cannot be assured through legislation. The best basic guarantee for ethical behaviour of doctors available to patients in the zone is their desire to stay in business and attract a constant flow of customers. Nonetheless, it should be possible to impose certain requirements on doctors which might increase incentives to behave ethically.

First, all doctors would be required to record treatments for each patient, much as they do under normal conditions. But this record would be written in layman's language. This is so that potential patients can inform themselves of the track record of a doctor, treatment or drug, by learning about the previous patients' history of symptoms, diagnosis, actions, and results. Patients may be encouraged to write personal accounts of their cases that are included in these files. Independent certification agencies might arise, which would use such material, and competitively assess the "track record" of each physician. The results could be published in "consumer's guides to medical practices."

Second, doctors would be required to video tape record initial consultations. In this way the explanations of the

risks, costs, and benefits of proposed treatments would form part of a permanent medical record. In cases where prospective patients' judgement is impaired, the interview would take place in the presence of relatives. These tapes would be stored for perhaps five years and be made accessible to authorities for random checks for compliance with the disclosure rules. Violations of the disclosure rules would be prosecuted under the penal code.

A zonal medical board

Third, there would be a board of doctors charged with assuring the maintenance of certain ethical and professional standards within the zone. This board might consist of one-third each of doctors from the zone, representatives of the provincial Medical Association and representatives of the provincial Ministry of Health. One task would be to rule on complaints of gross negligence lodged by patients or their representatives. The board would apply effective sanctions against doctors or clinics found guilty of violations. It would administer a fund out of which patients could be compensated for gross negligence. This would further prevent victims from becoming public welfare burdens. The fund would be financed by contributions from doctors and hospitals, with rates graduated by past records of causing expenses for the fund.

The preceding list of methods for protecting patients in the zone and the public is suggestive rather than exhaustive and precise. However, the principles underlying the methods for protection are clear: decisions are left to individual doctors; monetary penalties are set up only when self-interest cannot otherwise be relied upon to serve the public interest. Regulations do not rigidly prescribe how long and in what manner drugs must be tested before they can be used; doctors and drug companies can allow results to guide their decision on use. Failure to meet performance standards leads to costs for their producers and for doctors prescribing them. Together with the normal desire to maintain a good reputation for the benefit of future business, this should provide sufficient protection for the public.

Summary and Conclusions

The establishment of free medical and hospital zones in Canada would permit many residents of Canada to find medical care at home, which otherwise could only be obtained abroad. At present, this is only an option for the rich. If the zones in fact become dynamic places providing treatments that push out the frontiers of medical science, Canadians as well as people from other countries, will benefit. More treatments can be sought there, and the knowledge accumulated in the zones will be diffused throughout the world.

The establishment of the zones would be a significant move towards the restoration of greater personal liberty and freedom of choice. People will do what they think is best for them, weighing appropriately expected costs and benefits in the light of their own preferences and attitudes towards risk. At the same time, however, by limiting deregulation to some geographic areas alone, all those who believe in the need for paternalism, or who have a vested interest in seeing it continued, can also be accommodated. They can continue to have their way by providing regulation and protection for the majority of people seeking treatment outside the zones.

CHAPTER 8

FREE BANKING ZONES

Banking Regulation

The banking industry in Canada faces a wide range of regulations and taxes. Thus, banks have to maintain non-interest bearing minimum reserves against their deposits with the Bank of Canada. They must maintain certain ratios of assets to liabilities and other components in their balance sheets. They must limit their business activities to certain types. They must file innumerable reports with Statistics Canada and the Bank of Canada. They must withhold taxes on interest and dividend payments to foreigners. If asked by law enforcement and tax compliance authorities they must make available to Canadian police authorities the names of depositors and borrowers and the recipients of interest payments.

These and other regulations and taxes were designed for three main reasons: to protect consumers from fraud, to assure the stability of Canada's financial sector and to provide the government with the means to control and regulate the growth of the money supply. Consumers were considered to need protection because during the 19th century frequently, and later somewhat more rarely, banks and other financial intermediaries in Canada failed, either as a result of deliberate fraud or simple, innocent mismanagement. These failures created classical externalities in the form of economic instability: bank failures caused the bankruptcy of otherwise perfectly sound firms that had lost their banks assets and could not meet their obligations. These in turn were forced into bankruptcy and pulled down still other sound firms, sometimes creating general financial panics, recessions and even depressions. Private individuals who lost their bank assets suffered greatly. Some lost their entire life savings and became public burdens.

Agents of destabilization

Apart from actual failure, banks have been alleged to cause great social costs through cyclical changes in lending policies. The amplitude of these waves in confidence were determined in part by real events, such as the discovery of new resources or the development of new technologies. They were caused partly by the psychological factors. But unregulated banking has also added to the amplitude of these business cycles. Bankers have themselves been caught up in the cycles of expectations. They have lent excessive amounts on overly generous terms in good times; they have overreacted in the other direction during bad times.

Modern banking regulation was designed to deal with these problems. Today, it is strongly paternalistic. It assumes basically that depositors need protection because they cannot be trusted to judge on their own the quality of bank management. Bank owners, in turn, are not trusted to maximize and preserve their wealth and thus not cause avoidable bankruptcies. For these reasons banks' investment decisions are subject to minimum reserve and capital requirements. They are examined regularly for the prudence of their lending policies. In essence, the business judgement of bank regulatory officials are used to supplement and override those of the banks' owners and managers. Public control over the money supply and interest rates was felt to be necessary for purposes of economic stabilization. The bank regulators would "lean against the wind," and attempt to reduce the magnitude of business cycles through interest rate policies and, in recent years, efforts to achieve a steady rate of growth in the money supply.

Unintended consequences

It can be argued, however, that bank regulations have gone too far and resulted in costs in excess of the benefits provided. According to this analysis, politicians and banking authorities have the strongest incentives to avoid bank-failures. Such occurrences would clearly be blamed on them. They would be punished accordingly by the political process.

On the other hand, the cost of regulation is diffuse and largely unknown publicly, or even by those required to pay

it. These costs take the form of reduced flexibility of the financial system, slower rates of innovation and higher operating costs. There are no interest groups who even make this connection. Politicians are thus free of lobbying efforts in this regard. As a result, these considerations carry very little weight in the decision-making process of politicians and regulatory authorities. Because of this asymmetry in the influence of costs and benefits, there is a strong presumption of over-regulation in banking.

More specifically, Canadian banks have larger spreads between borrowing and lending rates than would prevail in the absence of regulations. One cause is the so-called minimum reserve requirement. This stipulates that for every \$100 deposit, a bank must maintain a cash reserve of X dollars with the Bank of Canada. This deposit earns no interest and leaves the commercial bank with a smaller amount of assets on which to earn income. The tax-rate implicit in this reserve requirement is very high. Then there are the so-called secondary reserve requirements. These force banks to accept portfolio compositions they would not have chosen voluntarily in the pursuit of profit maximization.

Bank oligopoly

Bank regulations have also encouraged a relatively comfortable oligopoly. The bureaucrats found their task of stabilization eased in dealing with fewer banks. They could establish intimate terms with only a small number of bank owners and managers. In return for co-operating with stabilization efforts, the Bank of Canada followed policies which protected existing commercial banks from excessive competition. Would-be new entrants into the industry, as well as other financial intermediaries, were discouraged. Oligopolists do not compete with each other for market-shares through lowering prices. Instead, there are other forms of competition, such as advertising, product differentiation, and the number and location of branches. As a result of this oligopolistic structure caused by government policies, Canadian banks have enlarged costs and spreads between lending and borrowing rates. These costs are paid by bank customers.

It is important to note that in almost all other countries of the world, national banking systems have been subjected to the same kind of regulation and taxation as Canadian banks. They too have mark-up margins much above those that would exist under free competition. In addition, in many foreign countries banks are burdened with the extra cost of administering and adjusting their portfolios to the mandates of exchange control systems. Fortunately this is absent in Canada.

Free Banking

Euro-currency banking developed in many countries from assets near zero in the mid-1960s to a total of about \$1,000 billion in 1981. Euro-currency banking arises when banks take deposits and make loans in currency denominations other than that of the host country. The phenomenal growth of Euro-currency banking is due to a gap in the regulatory framework in most countries, which exempts deposits in foreign currencies from minimum reserve requirements. In addition, foreign currency deposits and loans tend to be exempted from exchange controls. Low communication and travel costs that followed the development of jet airplanes and transistor technology have made it possible to carry on banking business and control over great distances cheaply. These cost-reductions thus produced the necessary conditions for the development of a global money and capital market functioning through the Euro-currency banks.

Savings from deregulation

The escape from required reserve deposits provides a very strong competitive advantage for Euro-currency over ordinary regulated banks. Consider the following example. Assume that a typical, regulated bank pays an average of 8 per cent on its deposits, earns an average of 10 per cent on its loans and faces a 15 per cent reserve requirement. Under these conditions, a \$100 deposit results in a gross income of \$8.50 from the loan (\$100 minus \$15 required reserves means a possible loan of \$85). With interest costs of \$8.00 on the deposit, there is a net return of \$.50 for the \$100 deposit. Out

of this margin the bank pays labour and operating costs and earns a profit. Assume that an average size regulated bank earns normal profits under these conditions.

Now consider that an equal sized Euro-currency banking operation is able to lend at marginally lower rates and borrow by paying marginally more than the domestic bank's 10 and 8 per cent, respectively. Its advantage is that it faces no reserve requirements because the business is carried on in foreign currency. On a marginal \$100 deposit that Euro-currency bank can earn \$10 through the loan, pay \$8 on the deposit, and enjoy a gross mark-up of \$2.00, or four times that of the regulated bank. If labour and operating costs are the same, say \$.45 per \$100, then the profits of the regulated bank are \$.05 and of the unregulated Euro-currency bank are \$1.55. This is 31 times the amount earned by the regulated bank, per unit of gross business.

The preceding, simplified example goes a long way to explain the dramatic growth of Euro-currency banking. It also explains why Canadian banks have been very active participants in Euro-currency markets and why their profits on foreign operations contributed proportionately much more to total profits than is explained by the relative size of domestic and foreign deposits. Thus, R. Collison reports ("The Birth of Petro-Banking," *Canadian Business*, December 1980, p. 41) that in the third quarter of 1980 the Royal Bank of Canada showed gross revenues of \$42 million on foreign operations that required only about one-third of the bank's total assets. Gross revenues on domestic operations were only \$33 million, but required the other two-thirds of total assets. After costs, Royal Bank's foreign operations contributed 51 per cent of the total. Other Canadian banks had similar experiences. Net profits on \$100 assets in 1979 were as follows: Bank of Montreal — International 68 cents, Domestic 64 cents; Bank of Nova Scotia — International 60 cents, Domestic 58 cents; Toronto-Dominion Bank — International 64 cents, Domestic 61 cents; Royal Bank — International 66 cents, Domestic 54 cents.

The Euro-banking business developed initially in England. This was due to the existence of traditional financial expertise in London and the presence of many multinational manufacturing and trading companies' head-

Table 8.1
Fifteen offshore banking centres: some basic data

	Ease of entry	Local capital requirements	Taxes and levies	Annual license fees	Number of offshore banks	Total offshore assets (in billions of U.S. dollars)
Anguilla	Until now, unregulated	None	None	EC\$1,350	100	...
Bahamas	Relatively easy, even for new banks	None	None	US\$300-45,000 ¹	263	70
Bahrain	Generally limited to branches of major international banks.	None	None	US\$25,000	37	21
Cayman Islands	Relatively easy, even for new banks	None	None	C\$5,000-15,000	260	12 ²
Hong Kong	Foreign banks are now being licensed after a 13-year moratorium. For the most part, only one branch of large international banks will be allowed.	None	10% withholding tax on interest paid. (proposed 17% offshore profit tax).		74 ³ 200 ⁴	11
Jersey	Only large, reputable international banks have been admitted.	None	£300 per annum for corporate tax companies.		33	2
Lebanon	Foreign banks must deposit LL7.5 million with the Treasury. Other new banks must have 50% Lebanese ownership and deposit LL4.5 million.	LL15 million ⁵	None ⁶		78	...
Luxembourg	Only large reputable international banks have been admitted.	Lux. F 250 million	40% corporate tax 40% municipal business tax 30% liquidity ratio		92	48
Netherlands Antilles	Extremely easy.	None	3-6% profit tax. No liquidity requirements	...	43	...
New Hebrides	Extremely easy.	None	None	\$A 1,000	13	...
Panama	Relatively easy for branches or subsidiaries of international banks.	US\$250,000	None	None	66	7
Philippines	Limited entry until profitability of existing operations has been assured. Major international banks favoured.	US\$1 million ⁷	5% profit tax (on offshore to offshore transactions) 10% profit tax (offshore to onshore).	US\$20,000	17	1
Seychelles	Limited to branches of subsidiaries of major international banks. ⁸	None	None	US\$20,000 ⁹	1 ¹⁰	...
Singapore	Relatively easy. Major international banks favoured.	S\$3 million	10% profit tax (on offshore operations).	S\$50,000	66	17
United Arab Emirates	Restricted licenses are limited, in theory, to reputable international banks.	None	None (at least in the Emirate of Sharjah).	None	55 ¹¹	...

Sources: Material from *The Banker*, *Banker Research Unit*, *Euromoney*, *Far Eastern Economic Review*, *Sunday Times*.

Note: Six centres are not listed because data are either insignificant or unobtainable. These are Barbados, Costa Rica, Guernsey, the Isle of Man, Nicaragua, and St. Vincent.

... indicate that data are either insignificant or unobtainable.

¹ US\$300 (nonactive banks) to US\$45,000 (authorized dealers and agents).

² Estimated assets in September of 1977 for the Cayman Islands and the Bahamas were US\$82 billion. Estimated assets in the Bahamas were some US\$70 billion.

³ Full license banks.

⁴ Deposit-taking companies.

⁵ Minimum capital if LL15 million of which LL4.5 million must be deposited with the Treasury. New branches of foreign banks must deposit LL7.5 million.

⁶ Since the declaration of the "Banking Free Zone" in March 1977.

⁷ US\$1 million must be held in any foreign-currency debt instrument of the Philippine Government.

⁸ Information provided by authorities.

⁹ Twelve with Restricted Licenses (offshore licenses).

Source: McCarthy (1979)

quarters, which provided demand for loans and supply of deposits. In addition, an understanding government and Bank of England provided an ideal climate for the growth for the business. However, the great success of Euro-currency banking in London quickly led to competition from other European countries and some centres in other parts of the world. In each of these centres, governments exempted foreign currency banking from reserve requirements and many other forms of regulation.

Paper centres

Table 8.1 contains a list of such Euro-currency banking centres. On the one hand, the list contains the description and conditions for operation of “paper centres” like Anguilla, Bahamas, Cayman Islands, Netherland Antilles, New Hebrides, Jersey, and Seychelles. Here, banks merely have a legal presence, typically represented by a sign and a post office box. Large numbers of banks have such paper offices. The banks do all of the actual work connected with their business — contacts with customers, book-keeping, etc. — in the home offices. They merely keep two sets of books for normal business and paper office business. But the paper centre is very profitable through the absence of some taxes, because of lower or non-existent reserve requirements, and due to the ability to assure customers confidentiality. The free banking zones proposed for Canada below would not follow the example of these paper centres.

Banking centres

On the other hand, Table 8.1 shows Euro-currency markets consisting of centres such as London, Hong Kong, Bahrain, Luxembourg, Panama, and Singapore. In these centres, banks operate genuine capital and foreign exchange markets. It is through these that the entire world is integrated into one, very efficient market. These centres arbitrage money balances in a very active inter-bank market, which leads to loans and deposits of usually very short maturities, much like the U.S. Federal Funds market. These markets also serve to bring together ultimate lenders and borrowers.

Lenders are oil producing countries in balance of payments surplus, multinational enterprises and government central banking authorities. Ultimate borrowers are developing countries with payments deficits, East European countries, quasi-government agencies such as utilities and multinational enterprises. To be successful, these centres must draw on such potential borrowers and lenders. Such a base usually is provided by a strategic location at international commercial crossroads, at gateways to rich hinterlands and in convenient time zones which permit a money market to operate when other centres are closed for the night. Typical of centres with such characteristics are London, Singapore, and Panama. As Table 8.1 shows, these centres can charge taxes on the profits of banks. The paper centres cannot do this without losing their patronage and even their modest license fees.

The New York International Banking Facility

U.S. banks are major participants in Euro-currency banking throughout the world. Like Canadian banks, major contributions to their total profits originate with these foreign operations. However, the financial community in that country recently began to lobby for the institution of free banking zones in New York, San Francisco, and Chicago. The U.S. interests argued that their participation in Euro-currency business abroad essentially represents a form of trade diversion harmful to the U.S. economy. There was strong opposition by smaller U.S. banks located outside the major financial centres who feared trade diversion for their own domestic business. After much discussion of the issues, the International Banking Facility in New York commenced operation on October 1, 1981.

The provisions under which banks in this free zone can operate are designed to assure a minimum of trade diversion. They also provide sufficient deregulation to permit competition with free banking in other parts of the world. Thus, zonal banks can accept deposits from and make loans only to foreign residents and to banks located in other International Banking Facilities.

The minimum size of transactions in the zone is \$500,000. Time deposits of non-bank institutions must have

a minimum two-day maturity or else notice is required prior to withdrawal. As a result, deposits cannot be used for domestic transactions purposes. Instead, they are most useful for wholesale international banking. The primary forms of deregulation consist of the absence of reserve requirements and interest rate ceilings.

It is expected that the operation of the business in the zone will induce a return to the United States of much of the banking business that had been diverted abroad. At the same time, the existing regulatory environment of domestic U.S. banking will be maintained. If the New York experiment is successful, similar International Banking Facilities will be established in other major U.S. cities such as San Francisco and Chicago.

Canadian Free Banking Zones

Canadian banks have for many years engaged in foreign currency banking not only in the major centres abroad, but also in Montreal and Toronto. This Canadian business is profitable because U.S. dollar deposits and loans, which constitute the largest share of all Euro-currency business, are not subject to Canadian reserve requirements. In addition, Canadian banks have not been subject to interest rate ceilings like their U.S. counterparts. They could therefore compete vigorously with Euro-currency banking abroad. The Canadian banks have exercised restraint by heavily promoting U.S. dollar deposits and loans in the domestic Canadian market. Instead, they have limited themselves primarily to international customers.

However, the Canadian Bank Act of 1981 has imposed reserve requirements on foreign currency deposits. This change was supported by other Canadian financial intermediaries previously excluded from Euro-currency banking. They faced increased competition from commercial banks, and could not use excess profits from Euro-currency operations to subsidize domestic business.

Germany is the only other major, developed country which has imposed reserve requirements on foreign currency deposits. When introduced in the 1960s, Euro-currency banking in Germany fell to zero very quickly.

Banks shifted their operations to Luxembourg and other neighbouring countries free from such requirements. There is a strong possibility that the German experience will be repeated in Canada.

A proposal

The preceding analysis has provided the foundations for the proposal that Canada establish free banking zones. Likely candidates would be Montreal, Toronto, and Vancouver. Banks would be relieved of regulatory burdens in the form of reserve requirements on foreign currency deposits, interest withholding taxes and expensive reporting requirements. As well, other seemingly minor regulations that represent a high proportion of value-added in the very competitive international market would be deleted. Furthermore, to protect the existing domestic regulatory environment, the zone banks would be limited to dealings with foreign banks and residents or to dealings in large sums by all potential customers. Under the latter condition, the zones would draw business from the global interbank market and from ultimate borrowers and lenders abroad. They would also attract customers from Canadian firms and wealthy individuals who are now dealing in Euro-currency markets abroad as ultimate borrowers and lenders.

Such free banking zones in Canada could capture a significant share of the world's Euro-currency banking business. The financial community in Canada has the required expertise. The domestic capital market represents a solid real base. Moreover, Canada's stable environment provides the opportunity for depositors to diversify political and country risks. A free banking zone in Vancouver would be able to exploit its location in the Pacific time zone. This would permit the operation of an international money market at a time when other centres to the east have closed and those on the western end of the Pacific Basin have opened. Such a market can arbitrage funds between Europe and the North-America East and Midwest on the one hand, and the Pacific Basin countries on the other. Vancouver's competitor in the time zone is, of course, San Francisco. But there is

no reason for believing that Canadian banks cannot capture a significant share of the business, given their world-wide operations and risk-diversification advantages.

Vancouver is also the gateway for the increasingly more important Canadian trade with the Pacific Rim. Such trade is accompanied by Canadian international transport and insurance. Firms engaged in these industries are likely to open additional offices or branches. Coupled with free trade zones, free banking zones will encourage warehousing, simple processing, and distribution activities related to this Pacific Basin trade. All of this international commerce needs, and is in turn encouraged by, access to a well-developed capital market. The proposed Vancouver free banking zone would provide such a capital market for both the lending of temporary excess funds as well as short-term borrowing.

Foreign banks

The genuine integration of Canadian free banking zones into the global capital market requires the presence here of foreign bank branches. The 1981 Bank Act permits some increased entry of foreign banks into the Canadian market, but it is doubtful whether the liberalization is generous enough to accommodate the needs of the proposed free banking zones. Therefore, it may be necessary to exempt foreign banks in the zones from the regulations which would otherwise apply.

Such legislation might be supported by Canadian banks since their own interests are served by the integration of Canadian free banking zones into the global capital market. Moreover, this access could be used to extract reciprocal concessions for the entry of Canadian banks into foreign markets. Because of the effective separation of free banking zones and domestic banking business, trade diversion from domestic Canadian interests to foreigners would be minimized.

Costs and benefits

This proposal would give a potentially significant stimulus to the economic development of the cities and provinces in which they are located. Studies of Singapore have shown

that the development of the Asian currency market may have added as much as 3 per cent to the country's national income. The economic prosperity of Switzerland and the role its financial sector plays are well known. This increased prosperity would serve all residents of Canada. There would be increased demand for housing and office space, requiring the hiring of construction workers. This would stimulate still other broad ranges of industry. Many overhead facilities such as telephone exchanges, airports, and hotels would be used more fully. Federal and provincial tax revenues would increase through the greater incomes earned and through the taxation of additional bank profits.

In the analytical framework of this study, the benefits to Canada from the proposed zone arise from processes of trade-diversion and-creation. Business of the zone will come from abroad, partly through the repatriation of Canadian business, partly through the diversion of foreign business and the creation of new transactions. Some transactions will, of course, be diverted away from the regular Canadian banking industry. But to the extent that it accrues to Canadian subsidiaries of these very same banks, and these national banks pay federal taxes, the negative impact on the rest of Canada is likely to be minimal.

Effect on inflation?

What about the external effects which banking regulations were designed to eliminate in the first place? Will their development not result in social costs that must be weighed against the benefits just discussed? Much of banking regulation has not dealt with externalities. Rather, it has served the special interests of oligopolistic banking. To the extent that this is true, deregulation through free banking zones produces no costs, only gains.

However, during the last part of the 1970s a debate has developed over the role which Euro-currency markets have played in the world inflation and currency instabilities of the 1960s and 1970s. It will be a long time before definitive answers come forth from this debate. In the meantime, in the absence of evidence to the contrary, we cannot conclude

that inflationary pressures caused by Canadian free banking zones would be other than minimal. After all, the billions of internationally mobile funds are already an actual or potential threat (or none at all) to the stability of the Canadian dollar and to world price stability. Canadian wealthholders seeking to escape investigative authorities are now placing their funds in confidential bank accounts in Switzerland and the Caribbean. The facilities the proposed zones offer would only return this money to our shores, with perhaps some additions. The world supply of money which alone may be related to world wide inflation would likely change only marginally, if at all.

CHAPTER 9

FREE INVESTMENT ZONES

History of Regulation

The investment securities industry in Canada, centred around the stock exchanges in Toronto, Montreal, and Vancouver, is regulated by the provincial securities acts and subject to the Companies Act and the Canadian Criminal Code. These laws and regulations require that investment brokers and salespersons be registered and meet certain standards of qualification. More important, they require that any issues of new securities be accompanied by a prospectus which discloses all the facts necessary for forming a judgement about the likely profitability of the security. Issues cannot be sold until this prospectus has been approved by the provincial Securities Commissions and thus has been deemed to disclose all relevant facts truthfully. Moreover, to protect the public's interest in securities trades after they have been issued, the laws and regulations require the immediate, continuous, and timely disclosure of all events which can be expected materially to affect the price of the security.

These laws and regulations governing the Canadian investment industry have been introduced in order to protect the public from fraud. Promoters are forbidden to enrich themselves at the expense of others by planting false stories designed to make investments appear more profitable than they actually are. They cannot sell shares at artificially high prices or at other times, by withholding good news about returns. They are restricted from buying shares cheaply before general knowledge of higher profits drives up prices.

Such disclosure rules result in genuine economies for society as available knowledge relevant for investment decisions is made accessible to the public at an efficiently low cost. Consequently, the allocative efficiency of capital mar-

kets is increased. Funds are more likely to flow to the most profitable undertakings. Public confidence and the low cost of access to the information encourages more capital to be made available in securities markets and in growth-producing risk capital.

Unintended consequences

However there are unintended consequences of existing provincial securities regulation. The most important arise from their detrimental effect on the issue and trading of securities by newly formed companies. These are the so-called junior companies. They have played an important role in the discovery and exploration of new mining and natural resource exploitation ventures in Canada. More specifically, the detrimental effects arise because regulations require the provision of information about the preceding five years' profits and losses and balance sheets. While such information is readily available for established companies, newly formed companies cannot provide it. To the extent that some data are available relating to other discovery and development activities, they are irrelevant for proposed new ventures. These firms simply have no sustainable revenues to report, only planned expenses and expectations.

A second detrimental effect is that the new and subsequent issues of shares require the time-consuming process of obtaining audited financial statements, preparing a prospectus and having it approved by the regulatory authorities. While such delays are not important for established concerns, they may cause financial issues to go unsold in the case of junior companies. For these firms are engaged in a speculative venture where speedy actions often are required. Promising leads must be followed up quickly, and personnel and machinery that have profitable employment opportunities elsewhere must be retained.

Red tape

There is the high cost of legal, secretarial, printing, and mailing services that have to be incurred in connection with filing and distributing prospectuses. This cost is great in relation to the scope of many junior companies. Yet, the

discovery and development of one profitable mine requires that a large number of individual ventures take place, each of which is a relatively small undertaking. But each and every one of these involves the expensive disclosure process. In sum, this constitutes a significant proportion of the total cost of getting into operation the few successful ventures.

As a result of these unintended consequences, the market for junior securities has suffered. It has become increasingly more difficult to undertake the discovery and development of new mines, although reliable evidence on these effects is difficult to obtain since they are closely linked with changes in world prices of minerals, inflation and tax policies. However, there is no doubt that these regulations have had, and continue to have, adverse effects on the formation and growth of junior companies in Canada.

A Proposal

The Canadian securities industry may be partially deregulated through the establishment of free investment zones in Toronto, Montreal, and Vancouver. The objectives are to reinvigorate and expand the market for speculative and junior stock issues. To this end, the Canadian securities markets would be allowed to define a new class of securities. These would be issued by entrepreneurs and promoters to finance highly speculative ventures not only in mining and natural resource exploitation, but also in new technological and industrial ventures. The principles under which these shares would be issued and traded are as follows:

1. Buyers must be made aware of the high risks involved in purchasing these securities.
2. Promotional material and the announcement of developments affecting the profitability of the ventures must be factually correct and prompt.
3. Compliance with these two principles would not be ascertained and certified by government regulatory authorities before sale or promotion. Instead, compliance would be assured by the imposition of private sanctions on members of the industry who have violated the two rules.

In this way, the cost of floating venture capital issues would be lowered and the process of marketing the securities speeded up. At the same time, potential buyers of securities would be reasonably well informed and protected from fraud. They would enjoy increased freedom of choice for the placement of their capital. And they would certainly realize that all their investment actions would be strictly at their own risk. *Caveat emptor* would be the order of the day.

Segregation

The establishment of free economic activity zones of any type is likely to be socially more acceptable if existing regulation can be applied without change to segments of the market where the need for protection appears to be strong. For this reason, the free investment zones in Canada would be created as separate divisions of existing stock markets. The precise method and strength of separation is a matter of choice involving many considerations. But the basic objectives would be attainable if the prices of stocks were listed in special newspaper tables, separate from those reporting the prices of regular stocks. The stock exchanges would set aside separate floor areas for trading. Brokers and promoters would indicate in all dealings with the public such as advertisements, bills, and letterheads, that they are dealing with securities listed in the free investment zones. If need be, all contracts in these stocks might be required to feature a skull and crossbones emblem; perhaps even a statement to the effect that these securities are hazardous, and may be dangerous to (economic) health.

In a 1979 report, the Vancouver Stock Exchange proposed a method for lowering the cost and reducing the time required for launching junior and venture capital securities. This represented an efficient method for assuring the availability of current information required by investors.

This method could be adopted by the proposed free investment zones. An “evergreen” file would be created, and stored at the free zones’ headquarters. This file would contain all pertinent information normally found in prospectuses. It would be kept current and available for public inspection. But these files would emphasize information about the identity and past performances of entrepreneurs

and promoters, and not as in the regulated normal market, the specifics of the planned use of the funds to be raised.

The evergreen file

The evergreen files would also feature current information affecting the firm's profitability. This would be done in order to assure access to relevant news by all market participants, directly or through their brokers. Of course, the concept of maintaining "current information" is of necessity ambiguous in practice. For example, at what stage of the assaying process of mineral deposits should findings be presented? Whatever stage is chosen can be interpreted as misleading in the light of information developing subsequently. Even the strictest set of regulations cannot avoid this problem. Because of the inherent ambiguity of the principle, the best protection for zonal investors lies in the desire to maintain a reputation of honesty, integrity, and service. Successful brokers and promoters can earn a great amount of money. They tend to be very reluctant indeed to jeopardize this income by deliberate fraud.

However, inevitably there will be some promoters and brokers who engage in fraud or at least use shady practices. They may think they can get away with it, or that the damage to their reputation is minimal, even if discovered. To protect the public against such operators, the free investment zone would establish a procedure for punishment. Not only would this have to be effective, it would have to be believed to be effective as well. Existing securities legislation can be used by a judicial committee of the industry to bring criminal charges against fraudulent promoters and bankers. But it is important that the free investment zones not leave this policing function to public securities commissions. For these bodies can and will accept such responsibility only if they can apply existing regulations to the zone. And of course this would defeat the very purpose of the proposed new institution.

Assuring Disclosure

To further assure disclosure, the Canadian free investment zones might prepare and distribute widely at nominal cost an official bi-weekly publication in which new entries in

evergreen files are publicized. Information on personnel affiliation changes would be included, so that investors who value individual promoters' or entrepreneurs' track records, can readily find out about them. Possibly, the publicity would be achieved by inserting the relevant material in the advertising sections of local newspapers. Such a method would keep the public informed at an efficiently low cost. This would reduce the need for and cost of special requests for information. In addition, it would have great publicity value for the industry.

Finally, the free investment zones might provide information about the historic performance-records of the securities they float and trade. With modern data processing techniques, it is easy to produce statistics relating the amount of money that could have been earned during a preceding time period from any particular investment. These would all be adjusted for the relevant transactions costs and withholding taxes. In addition, data on the distribution of yields from all stocks could be compiled. Thus it would be possible to learn how many stocks yielded different, specified rates of return over a certain period. These data would be juxtaposed with pay-off schedules from major Canadian lotteries and similar statistics from regulated markets.

Benefits

The establishment of free investment zones in Canada would give an important boost to the investment industry. The number of financial offerings by junior companies would increase. Speculative ventures from Canada, the United States, and the rest of the world might be attracted here. If so, Canada could become the speculative investment capital of the world.

This expansion will increase government revenues. It will more than cover the cost of the increased services the provincial governments will have to supply. Tax revenues also increase as personal earnings are raised.

As a result of the increased number of junior companies in Canada, exploration and development activities for mines and other natural resources can be expected to increase. This will result in greater demand for and incomes of the

firms providing services and equipment used in these activities. Most important, in the longer run, such activities lead to new production ventures such as operating mines, oil- and gas-wells, fish farming and processing enterprises, and wood-processing factories. Kalyon (1978) found that Ontario junior companies used up 28 per cent of the funds spent in exploring for new mines, but produced 62 per cent of the economic discoveries. Given the importance of resource-based industries in Canada, there must be a continuous, low-cost flow of discoveries of new resource deposits.

...and costs?

Some investors will undoubtedly lose money through the exercise of poor judgement, the receipt of poor advice from promoters and brokers, and the fraudulent behaviour of some members of the industry. Losses of this sort are unavoidable even with the strictest of government regulation.

Despite these losses, it is not desirable that the public be deprived of the opportunity to engage in investment gambles, even if these involve high probabilities of loss as well as low probabilities of very large gains. Free investment zones are for people who reject government paternalism. They are for people who prize their freedom and wish to be allowed to take risks. Having entered these markets in the full knowledge of the facts, as the proposed institutions assure, losses by these investors for any reason cannot legitimately be considered to involve a social cost.

One may reject the preceding argument about the absence of social costs from investment losses. If so, the basic issue which should determine the overall social merit of free investment zones is whether the benefits outweigh the costs. Given the often hidden but large losses involved in business regulation, there is little doubt that the cost benefit calculation gives strong support to the creation of free investment zones in Canada.

CHAPTER 10

FREE INSURANCE ZONES

Rationale for Regulation

The insurance industry in Canada is heavily regulated in order to protect the public from fraud and the consequences of insurance firm bankruptcy. In some provinces, public corporations have been given monopolies to provide automobile insurance. Allegedly, this is in order to exploit economies of scale. But in reality, this is done as an instrument of income redistribution policies.

There is no doubt that consumers have been defrauded by unscrupulous insurance companies, and victimized by insurance company failures. Also, there may well be substantial economies of scale in the operation of essentially compulsory automobile insurance. To the extent that insurance regulation has reduced fraud and failure and the public monopolies have exploited scale economies, they may have brought about social benefits.

However, there are important questions involving the magnitude of the benefits, especially in relation to the hidden costs of regulation. These costs consist primarily of reduced flexibility of underwriters to deal with unusual types of hazards and large risks. Public monopolies create inefficiencies by setting premia rates on politically motivated non-economic grounds. The result is an increased incidence of moral hazard.

Lloyd's of London

The lack of flexibility resulting from regulation is strongly reflected in the success of Lloyd's of London. Citizens of Canada, the United States, and other countries must patronize Lloyd's if they wish to insure against such hazards as accidental damage to the hands of a pianist, the cancellation of the Olympics and the resultant loss of television

broadcast revenue, the failure of earth-satellites to be placed in orbit and function properly, the cancellation of computer lease contracts and the sinking of large oil tankers. These are the kinds of insurance policies which Lloyd's is writing and which heavily regulated Canadian firms cannot offer.

Regulated firms cannot underwrite hazards of this nature because they tend to be unique. There exist no experience ratings which regulatory agencies can use to approve the premiums suggested by firms. Therefore, regulatory agencies typically do not issue licenses for the underwriting of such hazards. Or else they do so only after the lapse of such a long time that the potential buyers have lost the need for or the interest in the coverage.

The amount of trade diversion caused by strong regulation can be illustrated by the experience of the City of New York. In 1950, insurance companies there earned 35 to 40 per cent of total U.S. life insurance and property liability premiums, respectively. By 1978 New York's shares in these two categories of premium income had fallen to 21 and 7 per cent, respectively (*The Economist*, November 17, 1979, p. 115). These declines took place despite the presence of the expertise required for operating an insurance business. New York continued to grow as the world's most important centre of finance and commerce all during this period. It was simply that the regulations induced insurance companies to take their business elsewhere.

Free Insurance Zones Abroad

In the analytical framework of this study, Lloyd's of London represents a free insurance zone, for it is subjected to none of the burdens of regulation in effect in other countries. Under this umbrella of freedom, the firm has grown along with the development of Britain's industrial output and commerce in the 19th century. In the process it accumulated a large stock of knowledge and expertise. It developed a unique method for sharing risk. This involves underwriters in unlimited liabilities, which creates customer confidence and assures prudent business practices. As a result of these assets, Lloyd's has grown into the world's largest insurance company with a 1979 premium income of \$4 billion.

In 1979 the government of the State of New York established an Insurance Free Trade Zone and a New York Insurance Exchange. The first is designed to permit insurers to underwrite certain risks with a minimum of regulatory hassle. The second is designed to permit insurance firms to participate in big reinsurance and surplus line business. The latter involves very large or unusual risks, such as the cover for an atomic power station or a diving-club.

How can the regulated and deregulated insurance business be separated? This is achieved in practice by allowing firms in the zone to underwrite without regulatory approval any risk requiring a premium of more than \$100,000 per year. Furthermore, any special risk found on a list prepared by the New York State Insurance authorities can be underwritten without obtaining approval, regardless of the size of the premiums. It is clear that the large minimum premium assures that only large, commercial risks are insured without the operation of government safeguards. The principle is that customers with such large risk exposures can be assumed to have the expertise required to evaluate the contract offered, and protect themselves from fraud. The list of special hazards represents recognition of the inability of bureaucratic organizations to make the kinds of commercial judgements required of insurers. The New York Free Insurance Zone is an obvious attempt to imitate Lloyd's practices in essential respects and to regain at least some of the business which existing regulation had diverted away from New York.

There have been no protests by consumer activists to the creation of the New York Free Insurance Zone. Its success is watched by the insurance industry in other states. Illinois is considering the establishment of a zone of its own if the New York experiment succeeds. The big question is whether the required expertise can be obtained. This can be done either by bidding away personnel from Lloyd's, or by training and operation locally. It may well be some years before the evidence on this is available.

Canadian Free Insurance Zones

The Canadian insurance industry has an opportunity to use its considerable expertise to serve not only the Canadian

market but possibly to lure customers from other countries. But the government must permit the establishment of free insurance zones in one or more major Canadian cities. Insurers operating in such zones could be limited to underwriting, without regulation, any risks with a minimum annual premium of \$75,000. The difference between the New York minimum could provide a useful competitive edge. Furthermore, instead of providing a list of special risks insurable without regulatory control, the government might simply authorize unrestricted underwriting of all risks not covered by existing regulatory legislation. Such an approach would permit more rapid response to technical and commercial developments not foreseeable at the time of preparation of the list, than is possible in New York.

Free zones devoted to providing special types of insurance may also be established. For example, a zone might be created in Vancouver where marine insurance can be written without regulation or taxes. Specialization of this sort may well give rise to economies of scale and to the development of expertise that brings commercial success. Such zones might be operated in co-operation with Lloyd's of London. Lloyd's might welcome the opportunity to diversify internationally its base of operations. This might help this firm combat the loss of business to the Canadian free insurance zones. The ideas are tentative, and presented only to suggest the potential richness of opportunities for free insurance zones in Canada.

Cost benefit analysis

Free insurance zones would bring back Canadian business which existing regulations have diverted to Lloyd's. Without such zones in Canada, even more business may in the future escape to New York and other U.S. free insurance zones. In addition, the local low cost availability of insurance for special risks would encourage trade expansion. Canadian firms would be induced to enter risky business they otherwise would have had to forego because of the unavailability of coverage. The increased demand for insurance expertise and other inputs used by the industry would raise Canadian productivity, incomes, and taxes.

The costs of creating the zones are minimal. Enabling legislation could simply be modelled after New York's. It is likely that the Canadian insurance industry would provide no opposition. On the contrary, it might welcome the opportunity to assist government with the needed expertise. If New York's experience is a guide, consumer opposition should be light or non-existent. If, after passage of the enabling legislation, Canadian industry cannot generate the expertise and business to make the zones a commercial success, not much will have been lost. However, in the light of the analysis of the cost of regulation presented in this study, there is a reasonably good probability that the Canadian insurance industry can profit from partial deregulation. This occurred in London and in New York as well.

NOTES

Chapter 2: The Benefits and Costs of Regulation

For a discussion of the role of free markets in the growth of Western market economies see Friedman (1962) and (1979). The misapplication of scientific engineering concepts to economics is discussed by Hayek (1980). Block (1976) shows the often overlooked social benefits provided by some of the most regulated and persecuted providers of services in the market.

Economic textbooks have devoted much space to discussions of market failures as justification for regulation. A fine Canadian study of rationales for regulation is Cairns (1980), which provides a substantial bibliography of writings critical of regulation. There is also a literature on the non-market failures which accompany regulation. This includes Stigler (1971), Peltzman (1976) at a quite theoretical level, and Wolf (1979), Moore (1976) and Weidenbaum (1979) at the more applied level of analysis. Owen (1978) provides directions on how interest groups can exploit existing regulations to their benefit.

Baumol and Oates (1975) and Dewees et al. (1975) present positive proposals on how market incentives instead of direct controls can be used to deal with externalities. The effects of drug regulation are discussed by Wardell (1979), Wardell and Lasagna (1975) and Grabowski (1976). Public insurance against unemployment results in costs in the form of moral hazard that are discussed by Grubel and Walker (1978). Public efforts to lower price and income uncertainty through the establishment of marketing boards are discussed critically by Barichello (1981) and Grubel and Schwindt (1977) and Borchering (1981).

Specifically Canadian analyses of the effects of regulation are Hughes (1979) and Cairns (1980). Two Treasury Board publications (1977) show the Canadian government's tendency to rationalize away the scholarly criticisms of regulation.

Chapter 3: Towards a Theory of Free Economic Zones

Hamada (1974), Rodriquez (1976) and Hamilton and Svensson (1980) use the pure theory of international trade to analyze the effects of free trade zones. Grubel (1982) serves as a basis for the present chapter.

The concepts of trade diversion and creation are found in Lipsey (1960) and applied in measurement by Iqbal (1979) and Truman (1969). Effective protection is analyzed carefully in Corden (1971) and summarized in Grubel (1981).

Chapter 4: Free Trade Zones

Information about the private benefits to firms and hosting governments resulting from free trade zones is found in Diamond (1979). Diamond and Diamond (serial) provide continuous information about the development of trade zones in the world. Current developments are also discussed in Kelleher (1976), Fernstrom (1976), Currie (1979), and Ping (1979). UNIDO (1978) reviews legal background material of established zones. Yew (1979) contains an explanation of Singapore's economic success, and in the process shows that the territory basically is a large free trade zone.

Recent information about the establishment and operation of free trade zones is found in *International Herald Tribune* (1979), *Business Week* (1980), *The Economist* (1980), (1981) and Hughey (1980).

Economic case-studies of free trade zones are few and none are very deep and conclusive. See Lester (1979), Vittal (1977), Jong (1976), Subrahmanian and Monahan (1978) and Naerssen (1979). UNIDO (1980) surveys this literature with a focus on developing countries.

Canadian literature in the field of free trade zones is very limited. Maitland (1979) and (1980) provides information on the work required to meet Canadian government regulations concerning imports and exports. Politicians' demands for Canadian free trade zones are reported in *The Vancouver Sun* (1980), Steven (1980) and di Panio (1978). *The Gazette* (1980) reports trade diversion from Canada into U.S. free trade zones. Revenue Canada (no date) explains the operation of the Canadian Drawback system. Bezeredi (1980) provides a history of Canadian free trade zone legislation.

Chapter 5: Free Enterprise Zones

There is no literature dealing with free enterprise zones in Canada. The British proposal is set out in United Kingdom Treasury (1980). Butler (1980) provides a history of the British proposal and the outline of a scheme for U.S. zones. U.S. legislation concerning the zones is discussed in Siegan (1979) and International Centre for Economic Policy Studies (1981).

Chapters 6 and 7: Free Gambling and Medical Zones

There is no literature dealing directly with the two types of proposed zones. Alderman (1979) discusses the development of gambling in Canada and speculates about its future growth. Wardell (1979), Wardell and Lasagna (1975) and Grabowski (1976) analyze the social cost of drug regulation in the United States. Their results apply almost directly to Canadian conditions.

Chapters 8, 9 and 10:

Free Banking, Investment and Insurance Zones

General studies of Euro-currency banking are Einzig and Quinn (1977), McCarthy (1979), Throop (1979) and Grubel (1977) and (1981). Scott (1980) details the mass of regulation affecting U.S. banking. Canadian conditions are studied by Collison (1980) and Lerner (1981). Cheng (1981) has an excellent description of the New York Free Banking Zone. Johnson (1976) and Hodjera (1978) analyze the benefits of free banking in Singapore and Panama.

Conditions of regulation and junior companies in Canada are described in Freyman (1978), Kalyon (1978) and Vancouver Stock Exchange (1979).

The Economist (1979) and Decaminada (1979) concern the New York Free Insurance Zone.

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