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FINANCIAL REGULATION IN THE GLOBAL ECONOMY AS PROPERTY RIGHTS

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"As pants the deer for cooling streams, so do I for regulation."
Alfred Krupp, 19th century German Industrialist

I. Government and the Innocence of Economics

People who spend their lives studying economics often develop odd attitudes towards government. Economists with a rightward perspective can become infatuated with the beauty of an untarnished free market economy - how its perfect symmetries create an astonishingly efficient information processing and action coordinating machine. To them, government is a nuisance that gums up this perfection and thereby destroys wealth, stunts progress, and harms people. Economists of a leftward persuasion see the free market economy as a soulless juggernaut, devoid of ethics or morality, that tramples human beings. They see government as a lash for taming the free market economy. By moving a supply curve left and a demand curve up, by raising a wage level here and lowering an interest rate there, government can infuse an ethical quality into what would otherwise be a soulless monster.

These two views are quite similar: for both, government is something outside the economy. From the right, it is sand in the wheels; from the left, it is a guiding hand. But in neither case is government "inside" the economy or, in economists' jargon, "endogenous".

Our basic premise here is that this is wrong. Both views are deeply misleading in a modern market economy, and were never really right. This is because the government has the critical role of defining and enforcing property rights, and of generally fostering efficient economic exchanges. An entrepreneur must be sure her profits are hers, or she will see little sense in launching a new business venture. An investor must be sure the money he entrusts to the stewardship of business insiders, whether directly through financial markets or indirectly through financial institutions like banks, is his property. Without this government role, an advanced free market economy is impossible. Thus the traditional right is wrong. In the 1990s, globalization is drastically limiting governments' ability to do more than this, so the traditional left misses the point too.

In drafting new approaches to financial regulation, both traditional agendas are thus wanting. Consequently, we feel the key to sound government policy in this area is to focus on the basic purpose of financial regulations: balancing corporate insiders' and investors' property rights. We make several detailed suggestions as to how this might be done.

II. Financial Markets, Financial Institutions and Corporations

People with ideas often have little money, and people with money often have few ideas. The purpose of financial markets and institutions is to solve this imbalance. People with ideas, or entrepreneurs, get financing from people with money, or capitalists, to undertake business ventures.

People with money entrust their capital directly to entrepreneurs through financial markets, or do so indirectly via financial institutions like banks. Successful entrepreneurs pay back handsome returns to investors, who in turn give the money back to the entrepreneurs to fund further business ventures. If this cycle, illustrated in figure 1, becomes established, an economy grows rapidly. If it does not, or if it fails, the economy fails too. This critical role for capital markets and institutions is why our economic system is called "capitalism".

[figure 1 approx. here]

Surprisingly, the magic ingredient that makes the cycle in Figure 1 work is trust. To outsiders who read of insider trading scams and other white collar crime, this sounds strange. People who actually run businesses, however, are often surprised that anyone else is surprised. The people with money, who economists call capitalists, investors, or savers, and who include everyone from rich heiresses to Canada Savings Bond owners, must trust the financial system enough to rationally believe they will get back more money than they put in. In short, the people with money have to more or less trust the people with ideas.

The financial system that inspires this trust is both a puzzle and a thing of questionable morality to many people from post-communist countries and from traditional third world societies. A Russian "biznesman" expressed the point succinctly to one of us recently: "Why do companies here pay dividends?" he asked. Public finance economists also often express puzzlement that companies continue to pay dividends during periods when dividends are heavily taxed. But the Russian was coming from a different direction - he though rational corporate insiders should abscond with the investors' money, as many of his entrepreneurial countrymen actually have.

In fact, average people in the West can entrust their money to financial institutions and markets with a high probability of avoiding fraud. We shall argue that fostering their trust is the primary and critical purpose of financial regulation. From this perspective, financial regulation and corporate governance regulation are two sides of the same coin. Both are about protecting investors' property rights.

Economists identify "property rights" protection as the weight bearing beam that supports the superstructure of a capitalist economy.[1] If an entrepreneur's profits are not clearly hers, she will see little point in organizing a small business. If a consumer's goods are not clearly his, his incentives to work and save are undermined. If an investor's securities are not clearly his, his incentive to save is perverted. At a very basic level, people must trust the "system" enough to view accumulating wealth as a rational strategy. One of government's

[1] For an overview, see Shleifer and Vishny (1996).

most important duties is the protection of investor's property rights over their investments.[2] Once investors can trust entrepreneurs and managers, and entrepreneurs and managers become worthy of their trust, value creating projects are financed and economic growth ensues.

Economists associated with the new "endogenous growth theory", such as Paul Romer, call diagrams like Figure 1 "positive feedback loops", and argue that they are critical in high income economies. Positive feedback loops are systems that re-enforce themselves as they operate. We believe the property rights protection aspect of financial regulation is such a system for three reasons.

First, protecting investors' property rights encourages more investors to enter the market, which makes financial markets deeper and more liquid. This reduces investors' fears of not having access to their money when they need it, and leads to more investment, which adds further to market depth and liquidity, which ... . Second, growth in financial markets encourages some entrepreneurs to specialize in acquiring information about companies, which encourages more investors to enter the picture, which ... . This feedback system is especially strong when the information gatherer buys a relatively large block of stock. Such an investor has a clear incentive to monitor and, if necessary, challenge corporate insiders' decisions, so her presence encourages smaller investors to tag along. Third, better access to capital encourages more new firms to start up, which increases competition between firms for customers. Under a sufficiently honest legal system, this should encourage corporate insiders to work harder and make better use of investors' funds.

II. The Governance and Regulation of Companies and Banks - Back to the Basics

In 1669, Radisson and Grosselier obtained the backing of Prince Rupert, cousin to King George XX of England, to establish a "Company of Adventurers to Trade into the Hudson's Bay". This, along with other newly formed companies to trade with India, the South Seas, and other newly opened markets, was one of the world's first corporations.

Until this time, business had always been a family affair. Families owned and operated stores, inns, looms, smithies, and all the other parts of a contemporary European economy. Wealthy families owned large farms, ships, or mills. But that was the scale of business. There was little that needed doing that a reasonably wealthy family could not manage. If extra money was needed, people could always turn to long-time friends and associates.

Trading into Hudson's Bay was different. It was a hugely expensive undertaking with unknown risks. If it succeeded, it also promised huge profits. Prince Rupert brought together representatives of a number of wealthy families, and obtained partial financing from each. No

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[2] King and Levine (1993) find that a more sophisticated financial system significantly increases economic growth. Sachs and Warner (1995) report that "economic convergence", the rapid growth of poor countries as they catch up with rich countries, is only possible if the poor countries pursue free trade policies and protect property rights.

single family was so exposed to this risky undertaking that failure would ruin it, yet each stood to do well if fortune smiled.

Later, huge canal networks and other major investments in industrialization would have to be financed the same way. There were simply too many projects that needed doing, and with promised big returns, for the limited number of wealthy families to handle. Investors had to pool their money together and entrust it to professional business managers - the people who actually handled the building and running of the canals, etc.

Hundreds, perhaps thousands of complete strangers handing over huge amounts of money to other complete strangers to build canals? It sounds like an engraved invitation to scoundrels and con-men. And it was.

The most celebrated scam of this era is the South Seas Company of England, though there were others equally colourful in other European countries. The South Seas Company was to handle trade between Britain and the southern waters of the Atlantic Ocean. Amid great hype, it raised huge amounts of money in the early 18th century. As far as historians know, it never got as far as even chartering a ship. In 1722, the South Seas Company and a host of copy-cat frauds were exposed, and thousands of people lost their savings - including Sir Isaac Newton. Corporate governance problems were front and centre in the first decades of modern business.

Though historians debate the true intentions of the British parliament, it passed the Bubble Act of 1722, which basically made companies with traded shares illegal. Other European countries took similar measures in response to similar frauds. (The Hudson's Bay Company survived because of a grandfather clause.) Of course, this was no solution. Britain and other countries needed large pools of money for industrialization - especially to build a transportation network. Parliament was soon in the business of granting waivers of the Bubble Act, or parliamentary "charters", to such businesses. The reason our banks are called "chartered banks" is because they were established by parliament under rules that descended from this era of British law.

When rail roads and large industrial factories came of age in the 19th century, the Bubble Act slowly gave way. Governments in Canada and elsewhere retained the responsibility of granting charters to banks, perhaps because banks are more central to public trust in the financial system than are other corporations. It is no overstatement to say that the evolution of financial and corporate law over the past three centuries was very much an attempt to clear the way for more Hudson's Bay Companies while shutting out more South Seas Companies. This is the explicit purpose of corporate governance law, financial regulations, and the implicit purpose of many other aspects of business law.

III. The State as Midwife at the Birth of Capitalism

The moral of the story is that capitalism depends deeply on people's ethics. Investors have to be able to turn over their money to perfect strangers with a reasonable expectation that those strangers will use their money honestly and try in good faith to pay a fair return. In a world infested with rascals, this seems a naive hope upon which to base an economic system. The South Seas fiasco convinced honest entrepreneurs, financiers, and bankers that they had to devise a credible way of convincing investors that they were, in fact, honest.

Banks and Financial Institutions

The purpose of banks was to sidestep the need for investors having to develop trust in business insiders. The investors need only trust the bankers to be sure that the business insiders deserve trust. Instead of needing information about every entrepreneur whose shares you wanted to buy, you just had to find a banker with good judgement and let him do the rest of the work. Thus developed the huge industry of financial intermediation.

Unfortunately, some bankers occasionally didn't measure up. From the beginnings of modern banking in renaissance Italy to the 1930s, bank failure was a continuing spectre. Spectacular failures of huge banks decorate the panorama of European, American, and Japanese history. Kindelberger (1978) argues that these repeated bank failures, as well as other crises of confidence in the financial system, triggered periodic breakdowns in the cycle of trust illustrated in figure 1, and that these breakdowns caused the depressions that occurred every couple of decades through the 18th, 19th and early 20th centuries.

Over the years, governments imposed increasingly strict regulations on the business of banking, usually in response to dramatic bank failures. Banking throughout Europe began along the lines now preserved in German *Discontogesellschaften*, or universal banks. Once a bank got the go-ahead from government to go into business, it could not only take in savings and make loans, but also fund business ventures, buy securities and real estate, underwrite new issues, and sell securities in house. Some of these lines of business are highly risky uses of depositors' money, and a series of scandals and bank failures in the 19th and early 20th centuries increasingly convinced most governments to enact reserve requirements of various sorts, and to restrict banking to "safe" activities like mortgages and loans. The exception was Germany, where a committee to study such reforms was dismissed by the newly elected National Socialist government in the 1930s.

Bankers themselves understood well the importance of keeping investors' trust, and so had little interest in diversifying into other lines of business. Banking was the business of guarding other peoples' money as yet other people used it. Bankers' mission was to protect their depositors' property rights while earning them as high a return as was safe.

Corporations and Financial Markets

Corporate governance is also about protecting investors' property rights. Here, the company's top managers have a fiduciary duty to act for shareholders, and are vulnerable to court action if they failed in this duty. Companies must hold meeting to inform shareholders of the companies' undertakings, and the shareholders elect boards of directors to oversee the managers. Shareholders have limited liability, so mistakes or wrongs by the stranger who managed the company cannot be blamed on an investor who knew nothing of them.

In short, all of modern corporate governance came out of a very real economic problem - honest entrepreneurs needed to be able to convince shareholders to trust them, and saw binding their actions by law as the best way to do this. Rascals would quickly be exposed, and honest entrepreneurs would be left to gather investors' money.

The Economic Importance of Trust

During this same period, businesses were coming to grips with trust problems in other dimensions too. Suppliers had to trust customers and customers suppliers. Merchants had to

trust middlemen, and everyone had to trust shippers (the people with the canals and railways). In a backwater agrarian economy, people had the luxury of only dealing with friends or family. In a modern industrial economy, business with relative strangers was the order of the day. Contract law, tort law, property law, and criminal law all developed to foster trust and punish betrayal in business.

The magnificent feats of a free market economy are utterly dependent on a pervasive atmosphere of trust between strangers. It is too time consuming and expensive, not to mention intrusive, for everyone to gather information themselves about the moral character of business people. The first and most essential role of government is to build and maintain a network of laws that remove untrustworthy business people from the scene. By establishing rules of good conduct, government makes a free market economy possible. The right-leaning economist who scorns government is ignorant of history. The left-leaning economist who laments the absence of ethics in business has not thought hard enough about how the economy works.

IV. The State as Capitalism's Wet Nurse.

Government is an integral and essential part of any capitalist economy. Government must establish and enforce rules of good business conduct to promote trust. This view of government is deeper and more useful than the leftist and rightist caricatures at the beginning of this paper. Government is now clearly affecting the economy, but the picture is still incomplete. Government is also affected by the free market economy.

With government making rules everywhere, business insiders and bankers quickly realized that they might be able to influence these rules to their advantage and to the detriment of their competitors. Politicians and bureaucrats, like everyone else, needed money – and businesses had lots. In countries where buying political favours with money was frowned on, there was always the possibility of favour trading – campaign contributions for favourable legislation, or job-creating investment in swing ridings for subsidies. Soon bankers were protected from foreign, or even non-local, competition; and businesses were sheltered behind other anti-competitive regulations, tariffs and quotas.

The view of government as a neutral referee that set rules, punished violators and promoted the public good in the interests of fairness alone now seems quaintly naïve. Yet this is as far as most economics textbooks, even advanced ones go. Yes, there may be "market failures", but if the government levied this tax or changed that regulation, we could get to the economy's "optimum". The mindset that government is a neutral referee still governs much of economic theory in public finance, industrial organization, macroeconomics and other subdisciplines - and so compromises the relevance of much of the policy advice they generate.

The Nobel laureate James Buchanan developed a theory of government, called Public Choice Theory, that takes into account the pervasive favour trading and patronage that characterize government. In Buchanan's economy, corporate managers consider an expenditure on political lobbying just as they consider any other corporate investment. If lobbying promises a higher return than building a new factory, the politicians will be wined and dined, and the building site will stay vacant. The more rules and regulations there are, the higher the return to lobbying becomes, and the more funds are diverted away from economically real purposes. Public choice economists call people who lobby government for favours "political rent seekers" and the returns they gain by lobbying "political rents".

Political rent seeking can easily multiply in a chain reaction that can stifle economic activity. If politicians and bureaucrats can expect payoffs for waiving regulations, they have a strong incentive to make more regulations, and onerous ones at that. As the number of regulations grows, the return to political rent seeking rises while that to building factories falls. Many development economists believe this is what went so drastically wrong in many less developed economies in the post war period. Entrepreneurs came to expect politicians and bureaucrats to confiscate all profits as bribes for waiving regulations, so legal private business ground to a standstill.[3]

V. Globalization: Weaning Business from the Tit of the State

In free market economic theory, things do not usually get out of control like that. Checks and balances usually come into play to damp down such things. You raise your prices too much and a competitor steps in to steal your customers. Only a monopoly can get away with gouging the public for long.

Monopoly Government

That is precisely the problem – for most of the past century, government was a monopoly provider of economic order. If a rival firm lobbies politicians and wins favours, you could be ruined. You have no choice but to lobby harder. If you lose the lobbying war, or refuse to participate, you fund the opposition in the hope they might be different – and wait for an election. Until then, you accept Pierre Trudeau's famous one fingered salute. If there is no prospect of changing the government (as in many developing countries in most of the post war period), you quit business and go into government.

This status gave government greater power to affect private economic decisions for good or ill than is now possible. Tools like taxes, subsidies, trade barriers, and capital controls let governments affect prices throughout a national economy. For example, a government could provide subsidies to a favoured firm that would let it market its output at lower prices. This theoretically gives it an "edge" that its immediate rivals could only get from R&D to devise new low cost technology.

In the post-war period, governments throughout the world came to view influencing corporate decision making as their legitimate responsibility. The economy was seen as too important to be left to business. Issues of social justice, fairness, regional equality, and national identity required an active public sector input. Governments began to pass increasingly detailed laws affecting financial markets and institutions, and corporations' access to them. The original purpose of government in a capitalist economy, defining and

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[3]The Peruvian economist H. DeSoto, in his highly influential book *The Other Path*, describes how it took his well funded economics research institute two years and huge bribes to get permission to set up a small business in Lima. Klitgaard's book *Tropical Gangsters*, tells similar stories about sub-Saharan Africa.

enforcing property rights to make the cycle in Figure 1 work, was forgotten in a surge of social optimism.

Perhaps the most comprehensive of these intervention strategies were so-called "industrial policies", government coordinated plans to by-pass financial markets and institutions completely, and to inject money into some firms and take it away from others through systems of taxes and subsidies. (Of course, individuals' taxes also went into the pot.) Although those directly involved in formulating and implementing industrial policies often have high praise for themselves, detailed empirical studies of industrial policies come to uniformly pessimistic conclusions. Even in Japan's post-war industrial policy, which for years enjoyed a mystical reputation for success, is now widely recognized as a mirage. Japan grew rapidly because of its high savings rate and rapid incorporation of foreign technology, but despite its industrial policy.[4] The Japanese government subsidized proven losers, and firms that received government money tended to perform even worse following the subsidies. Everywhere, government subsidized corporations have attracted reputations for pork, inefficiency, and corruption; and have no proven track record for stimulating overall economic activity. Even touted success stories like Airbus Industrie S.A. have less sparkle when investigated closely.[5]

Why do "industrial policies" and other forms of government intervention in the finance business not work? The answer has two parts.

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[4]See Beason and Weinstein (1993) for a detailed statistical analysis of the assistance granted by the Japanese Ministry for International Trade and Industry.

[5]*The Economist,* February 3, 1996, p. 68 reports studies showing that Airbus fails to make enough profits to cover its subsidies.

First, direct government intervention itself needs to be financed. One source is taxes on individuals or on other businesses. Taxing individuals reduces their spending power and thus slows the economy.[6] Taxing other businesses slows their growth. Government borrowing, although a substitute for taxes in the short term, is just a mechanism for delaying necessary tax hikes until the government's debts come due. Governments that accumulate large debts, like Canada's and Italy's, also end up having to devote steadily larger fractions of the budget to interest payments, and face a steadily worsening tradeoff between raising taxes and cutting spending. An alternative source of funds for the government is newly printed money. This option leads to inflation, another form of tax. Countries, like Brazil, that have become politically committed to large scale government programmes but have no reliable tax base, are destined to suffer more or less permanent hyperinflation. If most subsidies go to losers, the typical industrial policy amounts to taxing winners to subsidize losers – hardly a recipe for success.

The second reason large-scale government involvement in the economy causes problems is that these well-intentioned policies erode property rights in the private sector, and this compromises the integrity of the cycle in Figure 1. Taxes erode private property rights and subsidies give public property to private individuals. Both render vague the property rights of investors in their investments and of business insiders in their businesses. In economies with already poorly functioning legal systems, large scale government involvement in finance leads many government officials into lives of corruption. Highly respected economists in third world countries soberly argue that the sole purpose of most government regulations that affect business and finance is to provide opportunities for bureaucrats and politicians to accept bribes for looking away.[7] A successful business is simply subjected to more inspections, permit requirements, and fines until its profits fall to zero. Clearly, this lack of property rights protection impedes development.[8] In these countries, industrial policies or other large-scale

[6]Keynesian arguments that tax and spend policies stimulate growth are now regarded as disproved. Such policies effects are only detectable in the very short term.

[7]See eg. DeSoto (1989) One should also notice that "industry policies" legitimizes entanglement between government and business and turns into sanctioned corruption and protectionism. See, e.g. the Wall Street Journal's Oct 9 article on the tainted blood scandal in Japan.

[8]Some eminent economists, notably Baumol (1990) and Murphy *et al.* (1990), argue that

programs of government intervention are seen as nothing more than smoke screens for establishing new bribe collection points. This cynical, but often realistic view encourages businesses to evade regulations and rules when they can, and to regard such behaviour as ethical. Clearly, this fosters and atmosphere of mistrust and makes capital difficult for entrepreneurs to obtain.

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this is the primary reason most third world countries remain mired in poverty.

Most advanced countries do not have this form of endemic corruption, though some, like Italy, appear to come close. However, even in Canada and the United States, political economy considerations influence government decisions. In 1984 the United States established long-term trade barriers against steel imports. The steel firms that benefitted from this policy were money losing, technologically retarded firms with large budgets for political influence buying.[9] In developed countries, political economy transactions are usually campaign contributions, favour trading, and patronage – not outright corruption. Yet the result is the same. A large-scale government intervention in the economy creates numerous opportunities for crypto-corruption. If lobbying politicians brings more benefits to corporate managers than does R&D, firms will lobby more and lay off scientists.

Economists tend to associate monopolies with trouble, and monopoly government is no exception. Governments throughout the world pursued variously wrong-headed but often earnest policies aimed at miraculously curing millennia-old ills like poverty. In doing this, governments neglected or abandoned their critical role as protectors of property rights and guarantors of trust, and set up huge bureaucracies that were deeply vulnerable to rent-seeking. Businesses that fundamentally disagreed with the way government supervised the economy had little choice but to wait out the bad times and give money to opposition politicians' campaigns. In this environment, lobbying and favour trading became the normal channels of government-business interaction.

Competitive Government

In early twentieth century London, private clubs proliferated. People interested in theatre joined theatre clubs, smokers joined smoking clubs, readers joined literary clubs, and misanthropes joined clubs where speaking was forbidden. James Buchanan developed a theory of government as "clubs": governments compete for citizens and their taxes just as clubs compete for members and their dues. A club with attractive rules gains members and wealth. Until recently, this was regarded as an intellectual curiosity by most public finance economists - a clever theory with little practical use. At best, the theory might describe adjacent municipalities or counties, but no application beyond that seemed plausible.

In the late twentieth century, as the reality of the global economy has become evident, Buchanan's view of government seems increasingly realistic. If people with entrepreneurial ability, money or skills dislike the rules one government establishes, they can do business under another. Government is now part of the competitive economy, not above it. If Canada's government charges more for running an efficient and orderly economy than do foreign governments, Canada loses economic activity to its competitors.[10]

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[9]See Lenway et al. (1996) for an empirical study of steel protection in the U.S. that supports these conclusions.

[10]MacIntosh (1995) independently comes to similar conclusions about financial regulation in Canada. His discussion parellels ours in many ways.

A key role in transformation is a growing importance of financial markets and a declining importance of traditional financial institutions like banks that take in deposits and make loans. In part perhaps because banks were protected from competition more than financial markets were, banks have been losing business to markets steadily since the 1970s. In the United States, competition from money markets forced the repeal of the anticompetitive "regulation Q" bank deposit interest rate ceilings in 1979. A series of reforms in Japan have dismantled legislative barriers (generally believed to have been devised by the large Japanese banks) that prevented Japanese firms from issuing traded bonds. New financial institutions have developed innovative ways of "securitizing" things like mortgages and student loans so they can be traded on markets instead of handled through banks. There is a clear trend in the advanced industrial economies towards greater "disintermediation" - that is, towards sidestepping banks and using financial markets to raise money instead. Deregulation of financial markets, mainly ending anti-competitive protection of brokers, dealers, and exchanges, has spurred financial markets to seize these opportunities.

Canadian banks have clearly understood these signs, and have moved to diversify out of the traditional business of deposits and loans. Canadian banks are involved in all aspects of securities transactions and in the design of new securities, and are present in financial markets around the world.

Financial markets are more footloose and free than was traditional banking. When most financial transactions were done through banks, a government could tax, regulate or supervise the banks and thereby control the transactions. With financial markets, this doesn't work. When John Kennedy tried to tax the foreign bond market in New York, it simply moved to London and became the Eurobond market. The more finance shifts to markets from banks, the more cosmopolitan capital becomes. In a system of global financial markets, and where markets in different countries compete for investors' funds, governments' control is minimized.

Yet globalization goes further than this. A typical Canadian toy store contains toys designed in the U.S., produced in Thailand using plastic from Canada, packaged and labelled in Hong Kong, shipped by a Taiwan company, promoted and marketed by both a British and an American company, and sold in a local retail store. There are licensing and other agreements between the U.S. toy -design property right owners and Asian manufacturers, the US distributor and so on. These agreements may be designed and monitored by lawyers in the U.K., Hong Kong, and even China. The toy designer has collaborative agreements with the Canadian-owned film producing company whose movie characters appear on the toys - the toy designer may even be the film producing company's subsidiary. Both may hire Irish to process their accounting data.

An immediate implication of this global economic interlinkage, and of the increasing importance of markets rather than banks for financing, is that difficult governments can be avoided. In a global market, Saudi plastic can readily replace Canadian plastic in the Thai factories if Canadian petrochemicals become more expensive. This means Canadian government policies that adversely affect Canadian petrochemicals firms can have huge and immediate consequences. And if a multinational petrochemicals firm, even a Canadian based one, finds that Canadian government policies create unacceptable costs, it simply shifts production elsewhere - taking jobs and economic opportunities with it.

Governments throughout the world are beginning to remember the critical importance of basic economic property rights, and are adjusting their laws and institutions to reflect this. This worldwide economic liberalization has greatly increased the number of plausible locations for production facilities. Advances in communication technologies and reduced trade barriers make locating production facilities abroad more feasible than in the past. These developments make businesses increasingly impatient with government ineptness in any one country.

These same developments make firms increasingly unable to tolerate poor government policies, even should they wish to. Globalization makes companies formerly separated by geography and politics into direct competitors. A company that accepts higher costs due to poor government cannot compete against other companies that do not.

In short, globalization means governments must design and implement only sound economic policies. If they do not, their economies will suffer more than they would have in the past. This is because businesses can now choose among competing jurisdictions for the government policies that appear most attractive.

This is deeply disturbing to many with vested interests tied to rent seeking. Politicians see their power to influence business curtailed. Civil servants' freedom of action in imposing and enforcing regulations is constrained. Social reformers can no longer force wealth redistribution. Tax authorities see national revenue bases becoming increasingly fluid. Entrenched Canadian corporations, whom government has sheltered from real competition, are facing real competition for the first time. Entrenched castes of labour, who obtained government-sanctioned monopoly status as labour suppliers to whole industries, face competition from workers abroad.

VII. Implication for Financial Regulation:

The globalization of the economy places new constraints on government policies of all sorts. Tax, social, fiscal, or regulatory policies that extract too high a price have immediate effects. Financial regulation is no exception.

Footloose capital can and will leave for other jurisdictions if Canadian financial markets and institutions do not appear trustworthy. The only way to stem such an out-flow is for Canadian investments to trade at lower prices and offer higher returns. At the same time, Canada's trust fostering regulations cannot impose too heavy a burden on entrepreneurs, or they too can go elsewhere.

Canadians are used to thinking of government as able to solve any problem, and too readily conclude that government deliberately ignores them or "doesn't care" when it fails to ease the burdens of their lives. This attitude must change. Canadians must be educated to appreciate the limits of government power. Viking legends record that the Danish high king, Canute grew weary of his ministers continual sycophantic lobbying and resolved to demonstrate the limits of royal power. He ordered his court moved to the beach, and decreed that the tide should not come in. He then had his ministers continue the normal affairs of state as the tide rose and drenched them all.

Globalization is much like King Canute's tide. It vividly highlights the limits of government power. Canada's governments have three basic options for dealing with this situation.

Option 1: Build Dykes Fast!

Canada can use taxes and investment barriers to wall off the outside world and "insulate" itself from the global economy. The essential idea is to protect the Canadian government's monopoly status as a provider of public order, and to seal off Canada's financial system from the rest of the world. This would allow Canada to implement laws detrimental to investors or entrepreneurs without an immediate flight of capital or ideas. There are several approaches to achieving this that Canada and other countries have tried.

One approach is to tax off-shore investment by residents. We feel this is unlikely to work. Multinational corporations can readily shift revenues and costs between jurisdictions to reduce their corporate taxes. Canadian individuals are becoming increasingly unwilling to tolerate higher taxes. Evasion of the GST is generally believed to be widespread, and is not regarded as unethical by a disturbingly large number of taxpayers. In short, raising the differential tax rate between foreign and Canadian investments by enough to deter foreign investment is unlikely to work, likely to stimulate further tax evasion, and would be politically unpalatable.

A second approach is to restrict off-shore investment by Canadians. Current rules on the foreign content of RRSPs and pension funds are examples of this policy. Unfortunately, an increasing number of Canadians in their 30s and 40s are convinced that government old-age pensions will not exist in a meaningful way when they reach retirement age. As this "baby boom" bulge in the population's age distribution becomes more concerned with retirement, rules that "protect" them from investing abroad are likely to be politically dangerous to any party.

Yet there appears to be considerable political sympathy for such policies in some quarters. First, some politicians and bureaucrats believe these policies help government borrow at low rates. Second, established Canadian corporations believe these policies help them to raise capital at low rates, and are grateful to politicians who help them do this.

It is doubtful that any practical market "closure" policies can actually make cheap capital available. Given the existing financial market integration in North America (e.g. cross-listing by Canadian firms, cross-border subsidiaries of financial service firms, the NAFTA) and the presence of off-shore markets, sophisticated Canadian savers should have little difficulty in by-passing capital control measures. Even if artificial market closure is successfully implemented, it gives Canadian borrowers cheap capital only if Canadian investment is less than Canadian saving. This does not seem to be the case - Canada has traditionally been a net capital importing country.

Consequently, it is improbable that such constraints actually reduce borrowers' costs of capital. They do, however, prevent investors from diversifying internationally, and thus burden Canadian investors with unnecessary risk. By limiting Canadian investors' investment alternatives, market closure regulations do ease corporate governance pressure on Canadian managers. If investors have few alternative places to put their money, they cannot punish badly run firms by selling out. Since most Canadian firms are closely-held, even large investors like pension funds can have only limited impact on management policies. (US activist pension funds like the California Public Employees' Retirement system (CalPERs) explicitly invest only in widely-held US firms.) This poor corporate governance reduces the values of outstanding shares held by Canadian investors, thereby reducing the returns they

earn on their savings. Yet any new shares must be priced low enough to provide a competitive return, so the companies' cost of new capital are not reduced.

In short, market closure adversely affects investors but probably does nothing to reduce borrowers' costs of capital. They create unnecessary financial insecurity, and exacerbate Canada's demographic savings/investment imbalance. Since large investors like pension funds can side-step such restrictions by using derivatives to bet on changes in the values of foreign assets without actually buying the assets, such regulations also encourage the use of derivatives. Most importantly, though, we believe regulations that many Canadians would see as cynical exploitation of their retirement concerns would only encourage further unhealthy contempt for government.

Existing differential tax treatment on foreign and Canadian investments should be abolished, quantity constraints on investment by pension funds and RRSP owners should be discontinued, and no new barriers of these sorts should be contemplated. Cheap captive savings is an "advantage" of the past. Canada's financial markets and institutions should be fully exposed to foreign and domestic competition.

Option 2: Breeding an Economy of Bottom Feeders

Conservatives often argue that the global economy means government must become radically smaller. Minimal financial regulation is often seen as a part of this.

Minimal financial regulation attracts capital to countries like the Netherlands Antilles and the Channel Islands. It stimulates vibrant money laundering industries and fosters financial expertise in the evasion of other countries' taxes and other rules. To some extent Canada has pursued this strategy with the Vancouver Stock Exchange's history of lax regulation, which it is attempting to change, and the Alberta Stock Exchange's "blind pools", which remain popular.

But ultimately, as we argued above, finance is about trust! The purpose of corporations, financial institutions and financial markets is to engender trust between strangers: the insiders who run the corporation and the investors and the capitalists who fund their undertakings. A "minimalist" approach to corporate governance and financial regulation ignores critical role of government in fostering trust.

How does Canada's current financial system stack up against other countries"? This is a complex question, and a simply scale is difficult to defend. One approach for gauging outsiders' trust in insiders, suggested by the Italian financial economist Luigi Zingales, is to compare the values of corporate shares that carry voting rights (and are usually held by insiders) with otherwise identical shares that do not carry such rights (and are usually held by outsiders).[11] If corporate insiders fulfil their fiduciary duty: to act in the interests of all shareholders equally, the difference in value should be small. If they do not, the difference should be large. Table I summarizes the results of several studies of this "voting premium" in different countries.

[Table I goes about here]

[11]See Zingales (1994, 1995)

Although the studies are from different years, the changes over time in any one country's average voting premium is small relative to the difference between that in Italy, where voting shares are worth 182% of the value of otherwise equivalent non-voting shares, and the US, where the ratio is 105.4%. Why is control worth more in some countries than others?

Zingales argues that it is because different financial systems represent different penalties to negligence, incompetence, or even larceny by crooked insiders. In short, control is worth more in Italy because the scope for theft by insiders is broader there.[12] These depressed public share prices in Italy mean firms' costs of capital are high in Italy. This sabotages the cycle of capitalist growth illustrated in Figure 1.

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[12]Caprio and Floreanti (1995) find that the voting premium in Italy has declined markedly, to just over 18%, recently, as criminal investigations have exposed corporate corruption. The also report evidence consistent with stock price manipulation as dominant shareholders sell out.. Smith *et al.* (1989) report a slightly lower average premium of about 10% on superior voting shares in 1987.

Investors, all else equal, prefer to place their money with people they trust. Several recent empirical studies present evidence that the biggest impediment to growth in many countries may well be a "trust gap" caused by their legal, financial, and regulatory systems.[13] Table I shows that Canada's system is better than Italy's by a large margin, but still might be improved. We believe their is little advantage in Canada moving towards the Italian low level equilibrium. A minimalist regulatory strategy is neither a necessary nor a desirable implication of globalization.

Option 3: Competitive High End Government

We believe the strategy Canada's governments should pursue is to provide "expensive government that's worth the money". Laws and regulations can be valuable to the economy if they promote trust, or investor confidence.[14] We believe there are several approaches to providing such a service.

Disclosure

A central goal of corporate governance regulation should be "transparency." Failure to disclose important information must be severely punished. Self-regulation cannot punish rascals as severely as government can, so a government mandated disclosure laws are sensible. If transparency helps Canadian firms earn and keep investors' trust, investors will acknowledge the lower risk by accepting lower returns. Companies, in turn, are attracted by this legitimately cheap capital.

Government must balance transparency against compliance costs. The cost of complying with disclosure regulations is a hidden tax , and too high a tax could drive business elsewhere. Regulations' value must justify their cost.

Financial institutions should have to disclose their non-performing loans and their exposures to risk. In the late 1980s, Principal Trust, an Alberta-based financial institution failed and wiped out many thousands of people's savings. A scandal ensued, in which it became evident that Alberta regulators had known for several years that Principal was in trouble, but had informed the public that its finances were sound. Meanwhile, Principal undertook questionable investments to remedy its troubles. Alberta regulators testified, in essence, that they were afraid exposing Principal's true picture would compromise public confidence in it, and hasten its fall.

We believe government regulators should never have been in this position. Had Principal been required to disclose its financial picture, the public would have begun demanding higher rates for bearing higher risk early on. It is at least an even bet that Principal's managers would also have been more careful custodians of other people's money if those people had known how their money was being invested.

In the case of financial markets, the important disclosure rules are those for public companies. Regulations should force the disclosure of items that well run companies should be

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[13]**See Shleifer and Vishny (1996) and King and Levine (1993).**

[14]See also MacIntosh (1995).

keeping track of for internal purposes anyway. This minimizes compliance costs. We present the following "wish list" of things we would like to know about the companies we invest in, and which we think most companies already know about themselves, but which Canadian law does not require to be disclosed.

R&D spending
Advertizing costs
White collar vs. Blue collar employees
Labour costs and management costs
Standardized lines of business accounting data
Standardized foreign operations accounting data
Pension obligations and assets at fair market values

In some cases, corporate insiders may fear the public's reaction to disclosure, for example, of CEO pay. We believe the answer is not to hide CEO pay, but to convince the public they're worth the money. This has been done with sports heroes and rock stars. CEOs should be an easier sell. If a firm creates wealth, jobs, exports, etc., its CEO's pay can be placed in perspective, and public support (or at least acceptance of high CEO pay) should be forthcoming. High pay for poorly performing CEOs might receive justifiable criticism.

Low Cost Trust

Financial regulation should try to foster the most trust for the lowest cost. Our current approach does not always do this. Many of our regulatory systems grew, through historical accidents and lobbying pressure, into rather high cost/low trust creatures.

For example, consider bankruptcy laws. Under Canada's (and most other countries') bankruptcy rules, a bankruptcy is a prolonged and disruptive process that further cripples the afflicted business. Much of this complication arises because the fate of the bankrupt firm and the disposition of creditors' claims are settled as one problem. In fact, they are two separate issues, and need not be confounded.

A simple alternative, would give the firm's creditors common shares on the day bankruptcy was declared, and then let them either sell their shares for cash or remain as owners of the firm.[15] At a shareholders' meeting, the new owners could decide whether or not to sack the management, restructure, or take other steps to increase firm value. Creditors who would have had different seniority rights under the old system would get different numbers of shares per $1000 of debt under this system. The old shareholders could each be given an "out of the money call" to buy back their shares by paying off a proportion of the firm's excess debts equal to their previous fractional equity ownership. The critical point of this scheme is that it totally separates the business of what is the best way to up the firm's value from the business of who gets how much. Bankruptcy could be cheap and socially relatively painless if we wanted it to be.

Instead, our bankruptcy rules are costly and disruptive, and Canadian businesses, investors, employees, and politicians rightly fear bankruptcies, especially large ones. This gives rise to a sort of "Peter Pan" approach to corporate governance. Canada is full of

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[15]The basics of this plan were proposed by Hart (1994).

century old "infant industries" that never grow up. When trouble arises, they cry out for government to wave its magic wand and bail them out. Peter Pan economics does win investors' trust, but it is a costly way of doing so.

Canadian banks made bad loans on speculative real estate ventures in late 1980's, and the government of the day felt bank failures would destroy trust. As Figure II shows, chartered banks' rate spread is now much higher than it was a decade ago, the banks are posting record earnings, and government has no apparent concerns about lack of competition.[16] In the 1970s, banks got into trouble with Latin American debts, and governments assisted in resolving the problem. In the 1930s, Canadian banks were virtually all insolvent, and the government cooperatively changed the definition of solvency.

Savers are paying for "trustworthy" banks with record low rates on bread and butter bank accounts, with high spreads, and with a bevy of service charges. Is this really necessary? Bank runs in the US in the 1930s may well have contributed to the depth of the depression by destroying public trust in the financial system. Yet there may well be easy ways to have bank failures that actually foster trust.

In principle, a bank could fail without missing a day's business. The banks shares could become options, and the banks creditors could receive common shares over a weekend. The bank could open under new interim management on Monday, and a shareholders' meeting a few weeks later could install a permanent new regime. Insured deposits would always be accessible. ATM machines might have to be closed the weekend of the bankruptcy.

Expect Sophistication

Third, regulations should foster financial sophistication, not dumb down investors and financial institutions. It is easier to trust people who know what they're doing. For example, calls to ban pension funds from using derivative securities are, we believe, misguided. Canadian financial institutions should develop the expertise to avoid poor investments, not be banned from any investments that might be poor. If they screw up, they should go under and their top executives should be disgraced. Reliance on bail-outs discourages competence.

Size

The deregulation of banking in the United States led to a wave of bank mergers, and to huge banks. It appears that there are large economies of scale in banking that justify large firms. One such economy of scale is perhaps related to trust: large banks have more expertise, more diversified portfolios, and more clout. Perhaps they are therefore more trustworthy. This may be so, but economies of scale come in different forms. If good risk assessment is the important type of expertise big banks have, then the competence and size of their risk management departments is more important that the extent of their branch systems.

Canadian chartered banks all have voting caps on their common stock. Voting caps are an early form of poison pill. They are anti-takeover devices that prevent any shareholder from

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[16]There is a fluctuation in rate spreads that moves with the business cycle, so this change might be due to factors other than anti-competitive behaviour. Still, the apparent lack of concern by government is of interest.

voting stock in excess of a uniform fraction of outstanding shares. These not only block takeovers, but limit large outside shareholders from exercising control. Canadian banks have grown by acquiring related financial institutions like trust companies and investment firms. But to grow to the size of their new US competitors, they need to merge or take each other over.

Banks' voting caps exist because parliament put them there. What sense do they make? They do discourage market power as measured by concentration ratios, but if foreign banks have free entry into Canadian markets, this ceases to be an issue. Voting caps prevent large foreign investors from taking over Canadian banks, but foreign ownership is no longer a hot political topic. Canadians are increasingly cynical about protecting "Canadian ownership" at the expense of consumer choice. The government's recent decision to prevent Border's bookstores from doing business in Canada, apparently to protect existing Canadian book chains, was a last straw for many people. In a world where governments everywhere are increasingly unable to pressure financial markets or competitive financial institutions, foreign ownership becomes unimportant. A third reason for voting caps on banks' stocks is that they prevent Canadian elite families from controlling banks. This may be a valid concern. In prewar Japan, which allowed industrial companies to own banks, these banks were particularly prone to crashing if the parent company had problems. Yet full voting caps are unnecessary. A better solution would be to prevent any client firm or related group of client firms from owning more than, say, 3% of a bank's stock. The bank's dealings with such shareholders should also be disclosed fully and promptly. This would prevent abuse, yet leave banks open to takeovers and to pressure from large institutional investors.

We believe Canadian banks should be allowed to attain whatever size considerations of efficiency demand. Ownership restrictions that prevent bank takeovers should be discontinued.

Corporate Governance

Corporate governance is about getting the best people in charge of public companies. As markets wax in importance and banks wane, corporate governance is taking centre stage.

Good corporate governance basically means having trustworthy and clever managers. The voting caps that protect the managers of banks, airlines, and other Canadian companies from responsibility to their shareholders are anachronisms, and should pass from the scene. Canadian banks and corporations of all types need their managers to be more irritated by shareholders. Large shareholders should be more free to communicate about corporate governance problems. Let shareholders oust top managers when the firm does poorly.

Outsiders should dominate boards of directors, and outsiders should be people with no business ties at all to the firm on whose board the sit.[17] Boards should have CEO compensation committees, CEO selection committees, and conduct committee to vet non-arm's length transactions that are all composed of true outsiders only.

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[17]For empirical evidence on the importance of outsiders on boards, see M.S. Weisbach, "Outside Directors and CEO Turnover" (1988) 20 Journal of Financial Economics 431; B.E. Hermalin and M.S. Weisbach, "The Effects of Board Composition and Direct Incentives on Firm Performance" (1991) 20:4 Financial Management 101.

Let shareholders sue top managers in class action suits if the managers fail in to be trustworthy stewards of the shareholders' money. To prevent frivolous suits, managers should have a clear "prudent man" defense.

Finally, ill run firms should be allowed to fail or be swallowed up as takeover targets. This is an uncomfortable, but essential part of economic evolution. If Peter Pan baits a shark, he gets eaten.

Pension Funds

Pension funds are a new kind of financial institution that is having an increasingly important impact on US financial markets. Multibillion dollar pension funds like the California Public Employees Retirement system (CalPERs) are using large blocks of stock to outvote insiders at shareholder meetings and demand improved corporate governance. The long-term effects of these interventions have yet to be studied, but the mere fact that insiders are being disturbed is good news to many investors.

Pension funds themselves are not immune to political rent-seeking, favour trading, and other governance problems.[18] Public pension funds run by patronage appointees and investing in politically favoured local initiative projects are unlikely to be positive long-term influences on the economy. Yet anecdotal evidence and one formal study suggest that this may be a widespread problem.[19] Corporate pension funds run by lap dogs of the CEO may be little better.

Pension fund managers need to be accountable to the fund's beneficiaries as directly as is possible. They should be elected by the beneficiaries and should report directly to the beneficiaries about performance.

Ideally, funds should be defined contribution plans rather than the ubiquitous defined benefit plans we now have. Define contribution plans take an employee's contribution and matching funds from her employer, and simply invest them. The employee knows how much she has and where it is invested, and knows who has performed poorly if it yields a low return. In short, the advantage of defined contribution plans is that beneficiaries' property rights over their investments are clear. Defined benefit plans, in contrast, promise employees a preset retirement benefit and commit the employer to invest the annual pension contributions to reach this goal. The fund managers are appointed by the employer, and may be pressured to follow an investment strategy that benefits the employer. In principle, if the fund does poorly, the employer must make up the gap. In practice, benefits are renegotiated regularly in labour contract talks, and can be reduced if the fund does poorly or if negotiators need concessions to balance other gains. It is very unclear that define benefit plans are safer from employees'

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[18]See eg. See J. Lakonishok, A. Shleifer and R.W. Vishny, "The Impact of Institutional Trading on Stock Prices" (1992) 32 J. Fin. Econ. 23.; see also J. Lakonishok, A. Shleifer, R. Thaler and R. Vishny, "Window Dressing by Pension Fund Managers" (1991) 81 American. Econ. Rev. 227.

[19]See Romano (1991).

viewpoints, and it is clear that they leave beneficiaries property rights vague and poorly protected.[20]

VI. Conclusions.

We believe financial markets are becoming more important than financial institutions like banks, and that this change is, in part, driving financial globalization. The purpose of financial regulations in any economy, but especially one in which financial markets are playing ever larger roles, is to foster investors' trust in financial investments, and to make corporate insiders behave in ways that justify this trust. This harkens back to the origins of both banking regulation and corporate governance laws: both were originally ways to let trustworthy insiders show themselves to be trustworthy. We believe financial regulation and corporate law have both lost sight of this purpose to some extent, and we outlines a series of detailed suggestions as to how this focus might be restored.

[20]**See Z. Bodie, J. Light, R. Morck and R. Taggart (1988).**

Figure 1. A Capitalist economy achieves sustained long-term growth once a cycle of this sort becomes self-sustaining. Investors entrust money to business insiders, who generate profits they share with investors, who reinvest more money. For this cycle to function, investors must have trust in the custodians of their savings.

SAVINGS

PEOPLE WITH
MORE MONEY
THAN IDEAS

PEOPLE WITH
MORE IDEAS
THAN MONEY

RETURNS

Figure 2: Canadian Commercial Bank Spreads: Mortgage Rates Minus GIC Rates.

Table I. The premium of voting stock over otherwise identical non-voting stock in various countries.

country	*average voting premium*	*study*
United states	**5.4%**	**Lease et al (1983)**
Sweden	**6.7%**	**Rydquist (1987)**
United kingdom	**13.3%**	**Megginson (1990)**
Switzerland	**20.0%**	**Horner (1988)**
Canada	**23.3%**	**Robinson and white (1990)**
Israel	**45.5%**	**Levy (1982)**
Italy	**82.0%**	**Zingales (1994)**

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