

Testing Charter Cities



Can new cities with better rules accelerate economic growth in Honduras and other developing nations?

BY KARL RHODES

Most major cities grew gradually over many years based on the advantages of their locations. But down through the centuries, a few cities have experienced explosive growth driven by novel rules and social norms.

Legal gambling, for example, quickly transformed Las Vegas from a desert water stop into one of the world's most successful entertainment destinations. Religious freedom became the main attraction to Philadelphia as it grew rapidly from a small Quaker village into the largest and most modern city in the British colonies. A market-based economy and British common law converted Hong Kong from a rocky island off the coast of China into a major center for international trade and finance.

Today, many prosperous cities offer religious freedom, the rule of law, and free enterprise — not to mention casino gambling. Yet many people are stranded in nations that lack the basic institutions that drive economic growth. Economist Paul Romer, of New York University's Stern School of Business, is trying to accelerate the global evolution of better rules by promoting his concept of charter cities — largely autonomous metropolises built from scratch — that would attract the hundreds of millions of people who are expected to migrate from rural to urban areas by the middle of this century. Charter cities promise to offer better institutions than those found in many countries.

Economists recognize the vital role of strong institutions — such as legal structures, market mechanisms, and financial systems — in the development of prosperous nations. Romer boils this concept down to the simpler idea of better rules, most importantly provisions in charter cities for free entry, free exit, and equal protection under the law. In addition to better rules, each charter city would provide enough

uninhabited land to accommodate millions of people. Residents could move in and out from host countries and from other nations around the world. Romer believes this new competition would accelerate the adoption of better rules globally.

People have applauded Romer's idea, which emerged from his highly influential academic research into how bad rules and antiquated social norms can slow down the application of beneficial new technologies. *Foreign Policy* magazine named him one of the "top 100 global thinkers of 2010," and *Harvard Business Review* listed his charter cities proposal among its "breakthrough ideas for 2010." But Romer wants charter cities to become more than an interesting concept; he wants to bring the idea to fruition. So in 2008, he formed a nonprofit organization called Charter Cities to encourage nations to try it.

The president of Madagascar expressed strong interest in 2009, but his political rivals forced him to resign (for unrelated reasons) before he could begin to implement Romer's proposal. But as one door closed, another one opened: A few months later, a coup occurred in Honduras, and officials from the country's new administration contacted Romer. By February 2011, the Honduran National Congress had amended its constitution to authorize a special development region — the Región Especial de Desarrollo (RED). And in July 2011, the Honduran congress passed a constitutional statute that broadly defined how the RED would be governed.

To help insulate the special zone from future political instability, the Honduran congress gave it a high degree of autonomy, but it stopped short of giving up sovereign control. The land would remain part of Honduran territory, and the government would place it in a trust to be managed by



RED authorities, including a governor and a Transparency Commission, both appointed by the president of Honduras.

The RED's ability to govern itself includes the authority to regulate currency. "Narco-trafficking and bribery are major challenges in Honduras," Romer explains. So the enabling legislation gives the RED the option to ban the use of physical currency. "The idea was not so much that a cash ban would be a panacea for crime, but that it could make illegal transactions and bribery more difficult and costly and send a clear signal about how law enforcement in the new zone will be much more stringent." This cashless option is an example of how Honduras has adapted Romer's charter cities idea to its own circumstances.

Nonetheless, Romer remains at the forefront of the RED initiative. President Porfirio Lobo appointed him to the interim Transparency Commission, and its members elected him chairman. (Romer has pledged not to profit financially from his involvement in the RED.) Other members of the commission include George Akerlof, professor of economics at the University of California, Berkeley and a Nobel Memorial Prize winner; Harry Strachan, founding partner of Mesoamerica, a consulting firm based in Costa Rica and Colombia that makes social investments through its foundation; Ong Boon Hwee, former chief operating officer of Singapore Power; and Nancy Birdsall, president and co-founder of the Center for Global Development, a non-partisan think tank in Washington, D.C., that develops ideas and promotes policies to reduce poverty.

Initially, the Transparency Commission would oversee the RED's legislative and executive functions, including the governor. As a check on the commission's authority, Honduras retains the power to change the RED's enabling legislation with a two-thirds majority of the Honduran congress and a referendum among residents of the RED, but Romer expresses confidence that Honduras will stay the course. The Honduran Congress is currently fighting off a constitutional challenge to the RED while working to determine the boundaries of the zone, which is expected to be

Can a charter city do for Honduras what Hong Kong did for China?

1,000 square kilometers, or about the size of Hong Kong.

Comparisons to Hong Kong are inevitable. Located in China, the semi-autonomous city-state grew rapidly after World War II under British common law and a market-based economy. Seeking to replicate that success, Chinese leader Deng Xiaoping established four special economic zones that also prospered, beginning with Shenzhen in 1979. He later opened 14 additional coastal cities to foreign investment.

"Britain inadvertently, through its actions in Hong Kong, did more to reduce world poverty than all the aid programs that we have undertaken in the last century," Romer says. There are many differences between Hong Kong in the 20th century and Honduras in the 21st century, but Romer believes the basic question remains the same: How can people in developing countries get better access to jobs in well-run cities?

"My focus on the potential for new cities in reform zones is an applied approach that I hope will lead to deeper insights about the dynamics of rules," Romer says. "Human progress is driven by the co-evolution of technologies and rules."

Lawyers, Guns, and Money

People can create new cities from scratch, "but it is complex, and the amounts of money involved can be very large," says Homi Kharas, deputy director for the Global Economy and Development Program at the Brookings Institution in Washington, D.C. He agrees that better rules could significantly boost economic development in the RED as long as investors are confident that Honduras will maintain its commitment to better rules.

"In order for this to work, one has to have some new institutional structure that enforces long-term credibility," Kharas says. "Whether or not that has to be backed up with military power and support is an open question. It certainly has to be backed up with legal and judicial enforcement."

To address that issue, the Transparency Commission plans to collaborate with partner countries that would help ensure the rule of law. "I had always imagined that the host [nation] and the partner countries would agree to the governance arrangement beforehand," Romer says. But the Hondurans realized that process could take longer than the political window they had to move forward. "Instead of reaching out to their allies beforehand, they drafted enabling legislation that leaves open opportunities for ample foreign participation."

For example, the island nation of Mauritius, off the southeastern coast of Africa, has agreed in principle to allow its supreme court to hear appeals from judicial cases in the RED. Mauritius has become one of the most prosperous countries in Africa since gaining its independence from Britain in 1968. It is a stable democracy with free elections and a positive human rights record. It also has attracted considerable foreign investment, partly by developing a

special export-processing zone that eventually led to lower trade barriers throughout the nation.

The Mauritian commitment is a start, but to attract enough financing to build a metropolis from scratch, the RED would need the sanction and protection of the United States to ensure stability, Kharas says. The United States is looking for alternatives to traditional foreign aid, particularly proposals that link foreign aid to trade and investment opportunities, he notes. "But usually those types of activities start off as small pilots. The difficulty with the charter city idea is that it is difficult to pilot on a small scale."

If not the United States, how about Canada? In April 2012, Romer and Brandon Fuller, director of the Charter Cities nonprofit, broached the subject in a paper published by the Ottawa-based Macdonald-Laurier Institute, a think tank that explores Canadian public policy issues. Fuller and Romer argued that Canada is particularly well-suited to partner with Honduras. "As a model of good governance in the Americas, Canada operates according to well-established rules and sensible reform," they wrote. Based on survey data from 2007-09, Gallup estimates that 45 million adults living elsewhere in the world would move to Canada permanently if they had the chance. Of all the countries in the world, that preference was second (a distant second) only to the United States.

Generous immigration policies alone cannot satisfy "this pent up demand for more Canada," Fuller and Romer wrote. But Canada could export its good governance by playing a strong leadership role in the RED. They suggested many possible areas where Canada could provide expertise including procurement, border control, customs, taxes, and law enforcement. The Royal Canadian Mounted Police, for example, could train and supervise police officers.

In late May, Romer outlined the Honduran initiative for the Committee on Foreign Affairs and International Development in Canada's House of Commons. Some members of the committee expressed interest, but none of them seemed ready to endorse the idea of Canadian participation.

Migration Power

Early American colonies attracted migrants who were ambitious, courageous, and determined enough to cross the ocean seeking better opportunities. So it is not surprising that these colonies prospered in the long run. The same was true for many American pioneers who pushed west — sometimes at the expense of the indigenous population — seeking natural resources, greater opportunities, and the chance to make their own rules in some cases. Romer and Fuller have contended that developing charter cities could "re-create the frontier conditions that give people new and better options" without conquest and coercion.

Today, the mobility of the world's population is limited not so much by the availability of arable land but by political barriers. North Koreans, for example, cannot simply stroll through the demilitarized zone to South Korea. Likewise, millions of eager migrants are trapped in African nations

that are plagued by drought, famine, war, and corruption.

"The gains from eliminating migration barriers dwarf — by an order of magnitude or two — the gains from eliminating other types of barriers," wrote Michael Clemens in a 2011 article in the *Journal of Economic Perspectives*. Clemens is a senior fellow at the Center for Global Development. "For the elimination of trade policy barriers and capital flow barriers, the estimated gains amount to less than a few percent of world GDP," he continued. "For labor mobility barriers, the estimated gains are often in the range of 50 percent to 150 percent of world GDP."

Kharas notes, however, that the biggest migration gains are generated by people moving from poor countries to rich countries. "When doctors go from Mexico to the United States, their salaries, their value-added, goes up enormously," he says. "That same logic does not apply to migration from poor countries to other poor countries." Honduras in particular, with estimated per capita GDP of \$4,300 in 2011, is among the poorest nations in the Western Hemisphere.

To reap substantial economic benefits from migration, the RED would have to succeed on a scale that would significantly improve the labor market of the entire country, Kharas says. But if the RED could provide better rules and opportunities for millions of people, and Honduras only has about 8 million residents, then why not apply the charter city concept to the entire country?

Cities From Scratch

It's often said that the three golden rules of real estate development are location, location, and location. Honduran officials have yet to define the boundaries of the RED, but Romer expects them to set aside uninhabited land with access to the coast.

"Here you are taking a place that was not a prime location to begin with, and you are trying to make it a special place," says Vernon Henderson, professor of political economy at Brown University. Perhaps better institutions alone will attract waves of immigrants and foreign direct investment to the RED, but Henderson doubts it. "You have to give them other forms of subsidies," he predicts. "You have to invest in infrastructure to try to overcome any deficiencies in the location."

Henderson says it would be difficult for a poor nation like Honduras to pump lots of money into a charter city. "I will be surprised if that actually happens because I think it will get bogged down politically," he says. "I understand that everyone is wildly enthusiastic now, but eventually you have to turn to the nitty-gritty of how you are going to put infrastructure in there."

Kharas is somewhat more optimistic about the prospect of building a city from scratch. The area of mainland China across from Hong Kong has sprung up from almost nothing, he notes. And so has the Iskandar project across from Singapore in Malaysia. Iskandar is an initiative of the Malaysian federal government and the Johor state government to develop a special economic zone to capitalize on

Singapore's success. "So it is possible to create new cities that end up being very dynamic," he says.

Clearly, location will be important to the RED, but Kharas is more concerned about how quickly the RED can achieve economies of scale and the economic and social networks that make cities efficient. On this point, Henderson agrees. "A lot of the efficiency of working in cities comes from networks and interchange of ideas and interchange of goods between firms and what goes on in a dense urban environment," he says. If those networks do not develop quickly, Henderson predicts that the economic base of the city will be limited to foreign direct investment — labor-intensive manufacturers that are looking for cheap labor in a stable environment where their factories are less vulnerable to expropriation.

"Investors are concerned about headline-grabbing expropriation in some parts of the developing world," Romer concedes. "But the much more salient risk is death by a thousand cuts — the ex-post manipulation of contracts in areas that involve shades of gray, be it by government officials or firms that specialize in exploiting weak governance." The RED's enabling legislation attempts to assuage such fears by instituting independent law enforcement and judicial functions and by allowing partner countries to appoint members to the Transparency Commission. Also, contract disputes in the RED could be subject to international arbitration and review by the Mauritian Supreme Court. Critics have charged that achieving stability via foreign influence and control amounts to neo-colonialism, but Romer argues that colonialism was based on coercion and condescension, while charter cities are based on giving people and governments more and better choices.

Who Gets What?

If the RED can achieve stability, credibility, and critical mass, it might be able to leapfrog ahead of other Central American cities that are encumbered by inefficient rules, just as Hong Kong and Singapore vaulted over more

established Asian cities. If that happens, Honduras would gain a booming new city, more international credibility, greater impetus to improve its rules, and a viable alternative for thousands of Hondurans who take great risks to move illegally to the United States each year.

Partner countries would support the RED to promote peace, stability, and prosperity in a developing nation — and because it's the right thing to do, Romer says. "Risk has not kept countries and international financial institutions from participating in traditional large-scale aid projects in the past," he adds. "The important thing now is to recognize that the traditional approach has had only modest success and then develop a willingness to try something different." By helping to set up better systems of governance, partner countries could have a more lasting impact on developing countries.

The United Nations expects the urban population in developing countries to double from 2.6 billion to 5.2 billion by 2050. "Under conditions of policy-as-usual, people will flock to slums that surround cities whose governments either do not want additional residents or are incapable of accommodating them," according to Fuller and Romer. "This needn't be the case. The coming wave of urbanization has the potential to dramatically reduce global poverty, and to do so in a way that is not dependent on aid or charity."

Romer is staking his growing reputation as a socioeconomic entrepreneur on the idea of charter cities. "The job of every economist is to make the world a better place," Romer told a Honduran newspaper last year. "Some economists do this by developing theories about how an economy works. This is what I did in the early part of my career," he said. "Now I want to make a practical contribution, a real difference in people's lives. ... My hope is that in the near future, every family on earth can choose to move to one of several different cities that are all competing to attract new residents," he concluded. "It would be the reward of a lifetime for an economist like me if I could help the world take even a small step toward achieving this dream." **RF**

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