

Is capitalism dead?

**Essay contest
winner: A failure
to capitalist
incentives**

by Michael Dial

**Why America needs
Canadian oil**

by Mark Milke

**Paying for a
freer culture**

by Tim Mak

Short selling

by Mark McGinley

Congratulations to
the winners of the
Fraser Institute's 2011

STUDENT ESSAY CONTEST

The winning post-secondary essay is in this issue, with
the other winning entries to be featured in upcoming
issues of CSR. For complete contest information, visit:

studentessaycontest.org

This year's topic was
"Is Capitalism Dead?"

Details of the 2012
essay contest will
be released soon!



The Winners

1st Prize (\$1,000)

A Failure to Capitalist Incentives

By **Michael Dial**, Maryland Heights, MO
Truman State University, B.A. Economics, 2012

2nd Prize (\$750)

Is Capitalism Dead?

By **Jennifer Lalonde**, Cookville, Nova Scotia
Mount Saint Vincent University,
BSc Applied Human Nutrition, 2015

High School Category (\$500)

Is Capitalism Dead?

By **Lori Ossip**, Toronto, Ontario
Tannenbaum Community
Hebrew Academy of Toronto, 2011

Canadian student review

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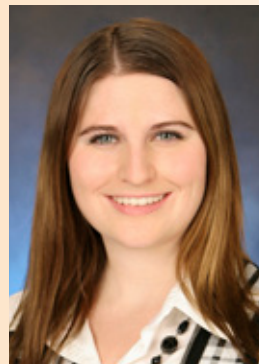
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Canadian student review

Welcome!

Dear Reader,

Our Fall 2011 issue features the winning
post-secondary essay from our annual
student essay contest, with the second
place post-secondary and winning
high school essays to be featured in
upcoming issues. Overall, the three
winning papers were selected from 180
entries from around the world, and the authors won cash prizes
for their answers to the question, "Is Capitalism Dead?"



In addition, this issue addresses the role of government in
funding arts and culture, how short-selling can be used to stop
corporate fraud in financial markets, the non-competitiveness
of the Canadian auto insurance market, and the importance of
Canadian oil to America.

Make sure to also take a look at our video on page 30, which
shows a typical day at one of free Explore Public Policy Issues
student seminars. Then, if you are interested, go to our website
at freestudentseminars.org to see if there is one happening in
your area this fall. As always, we are looking for new articles on
economics and public policy from student authors. See the back
cover to find out how you can get published in *Canadian Student
Review* and earn \$200.

All the best for the new school year,

Lindsay Mitchell
Editor, *Canadian Student Review*

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What's new from the Institute

1st place essay contest winner

A failure to capitalist incentives

Michael Dial

“Economic progress, in a capitalist society, means turmoil” (Schumpeter, 1949). For reasons similar to this, eminent leaders from government (Nicholas Sarkozy, France’s president) to academia (Richard Posner, a University of Chicago law professor) have called for a retreat from capitalism and the advance of state regulation. According to the critics, the regulated economy is supposed to bring greater certainty and a safer environment for sustained economic growth. Is there reason to support the argument that increased regulation would create a less

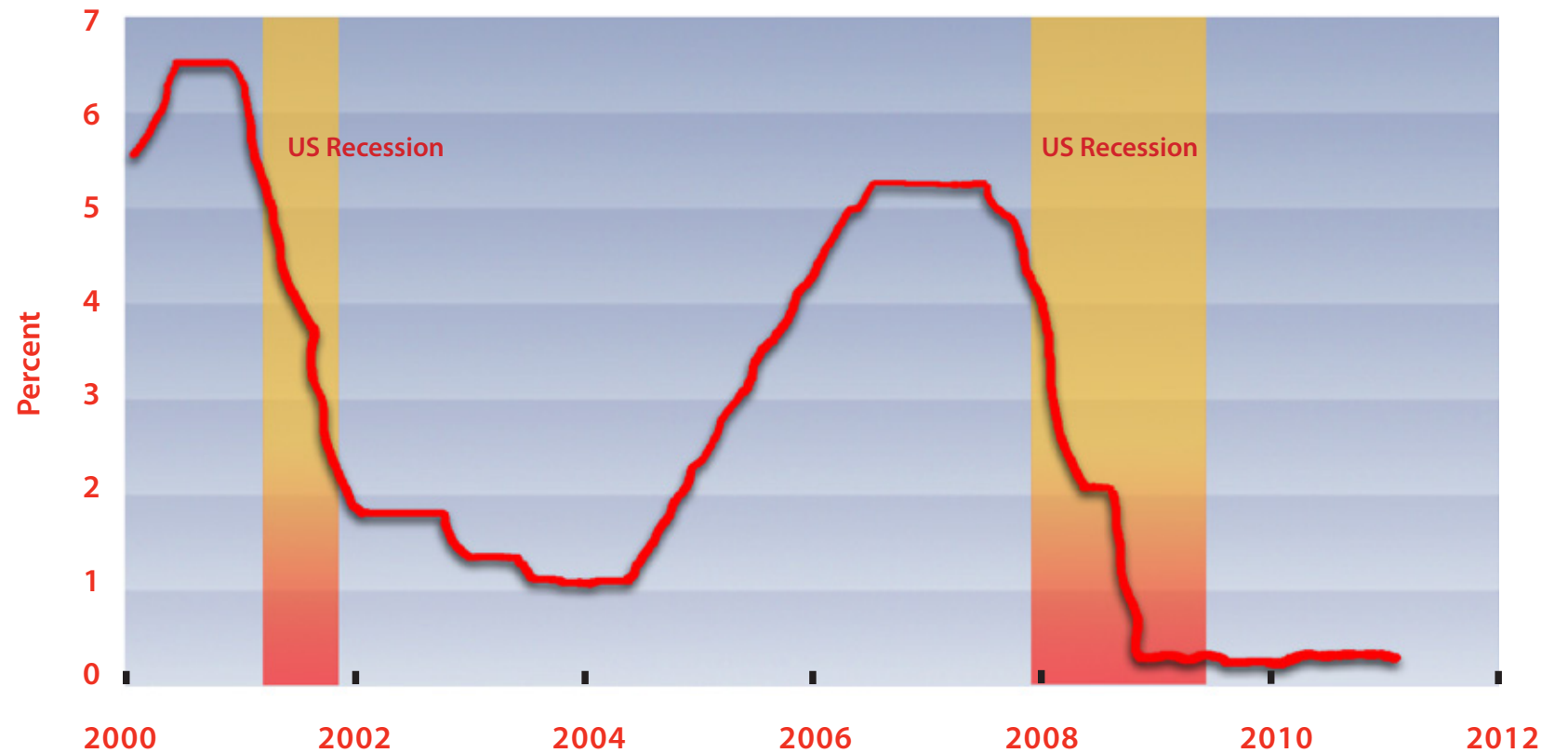
severe business cycle? Evidence indicates the heavy hand of government is responsible for the severity of the recent recession, not that the capitalist model fell apart under its own weight.

There is a general consensus that the cause of the financial crisis was a (housing) bubble. A bubble occurs when an asset class (residential property) grows in value much faster than the asset's economic fundamentals. The bubble can be self-inflating; investors will continue buying, essentially increasing demand faster than supply, driving up prices. Easily available credit, as was provided by the US government, facilitates the large increase in investment.

During the financial crisis, when prices finally stopped their meteoric rise, the housing bubble popped and prices fell as buyers disappeared, erasing savings and causing the sale of other mortgage securities to cover liabilities, which drove down prices and further erased wealth. Credit dried up as bank residential assets fell in value; constricting the ability of firms to operate and of entrepreneurs to function and make the necessary investments for job creation. Not only were new jobs not created, but the existing jobs were cut because demand fell with the lack of credit (Posner, 2009).

Agreement ends here; critics of laissez-faire capitalism point to excessive risk in

Effective federal funds rate (FEDFUNDS)



Sources: Board of Governors of the Federal Reserve System; 2011 <<http://research.stlouisfed.org/>>.

the financial sector in pursuit of profits and insufficient regulation of complex financial vehicles. However, this response leaves two important questions unanswered: where did the capital to fund the housing asset come from; and what encouraged continuing investment in the bubble? Critics point to excessive saving abroad that was able to fuel the mal-investments in America (Posner, 2009). This isn't supported by the numbers; net direct

investment in 2007 was less than \$70 billion. Net direct investment in prior years, particularly in the late 1990s and early 2000s, was at this level or higher (Federal Reserve Bank of St. Louis, 2011). This is a large sum of funds, but as a share of the US economy in 2007, it is less than 1 percent (GDP was over 14 trillion in 2007), not enough to fuel the housing bubble, even assuming that all foreign investment flowed into housing.

Asset bubbles, recessions, and shifts in investment are all inherent parts of a free market economy



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Critics of free enterprise then point to irrational exuberance as the market mentality that continued to inflate the asset bubble. Investors will take risky loans and continue to increase leverage because greater leverage means greater returns (or losses). In a bubble, as asset prices rise, investors perceive more wealth so they continue to invest, or even keep savings in the form of assets, further driving prices (Posner, 2009).

Asset bubbles, recessions, and shifts in investment are all inherent parts of a free market economy and can arise on their own in the absence of government intervention; yet a recession of the magnitude of that in 2008 can only occur when aided by incentives and price mechanisms that are distorted by the government (Minsky, 2001). The Federal Reserve first distorted these price mechanisms and incentives by artificially manipulating

interest rates, in effect sowing the seeds of the current crisis. In response to the recession that began in 2001, the Fed artificially lowered short term interest rates through open market operations, and kept rates down to encourage economic recovery (see graph on page 5). Investors see interest rates as a price mechanism to show the price of capital; when they are low, entrepreneurs take out more loans because it is cheaper to borrow

(Mahoney, 2001). In the current financial crisis, the low interest rates set by the Fed in the early and mid-2000s made buying houses cheap, and created the perception that the high demand for housing would continue, and that consumers would be able to pay their mortgages. As this illusion proved false, the housing bubble popped, and the financial system unraveled.

Interest rate manipulation explains where the funds and the initial impetus for the housing bubble came from; but why did savings continue to flow into mal-investments (misallocation of capital) even as it became apparent an enormous housing bubble was forming? Investors wouldn't continue to make

investments in an increasingly risky market without proper incentives. Critics argue that the increased risk from greater leverage increases the profit potential (Posner, 2009). However, it also increases the loss potential; a fact not lost upon entrepreneurs. For investment to continue, there needs to be an attribute of the market that discounts the risk of failure while maintaining the opportunity of profit. The perils of principal-agent relations can be used to explain some of the rationale for the risky investments as mutual fund managers looked to gain higher returns with little danger of the losses being tracked back to them. However, the moral hazard of government bailouts played an important part in distorting capitalist incentives as firms

embarked on risky investments because they were insured from financial failure (either implicitly or explicitly) through a government bailout. The best example of moral hazard, which also set the tone for the mal-investments leading up to the current financial crisis, is the bailout of Long Term Capital Management (LTCM) in 1998. LTCM was a very large hedge fund invested across the world, particularly in Russia. LTCM had leveraged its assets more than 30 times over to invest billions of dollars. When Russian debt began to default, LTCM had to call in assets to pay off its liabilities. The ensuing panic made LTCM insolvent, creating a possibility of billions in losses and a financial crisis. Fortunately for LTCM, the Federal Reserve stepped in, lowered interest rates and organized investors to recapitalize LTCM, effectively bailing it out (Posner, 2009).

These events introduced a moral hazard and the concept of "too big to fail," which helped inflate the housing bubble. Fannie Mae and Freddie Mac guaranteed mortgage-backed securities with the full faith and credit of the US government (Fannie Mae, 2011), so investors subsequently had the incentive to continue to leverage their assets in the face of increasing risk. Firms had the expectation that if they became too big to fail, the government would bail them out, which distorted the benefits and costs of investing during the bubble. As the expected benefits exceeded costs, firms had a significant incentive to pursue riskier

Incentive distortions by Freddie Mac and Fannie Mae helped drive the financial crisis



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investments than they otherwise would have. These arguments bring us to the conclusion that it was government regulation, not a lack of government intervention, that created the incentives that drove the economy into a financial crisis. The incentive distortions created by artificially low interest rates and a moral hazard of government bailouts perverted the incentives to firms. Distorted interest rates and an implicit government bailout provide the rationale for firms to increase risk in search of greater returns. Since it is impossible to identify an asset bubble until the bubble begins to deflate (Posner, 2009), any firm that does not invest in an investment that is not part of an asset bubble will become uncompetitive. Government intervention forced out safe investors and firms which would have limited the effect of the financial crisis.

American history shows that periods of relatively undistorted incentive structures were able to deal with financial crises in a more effective manner. The US economy endured a period of deflation from 1870-1897. Instead of a period of low investment, high unemployment, and slow economic growth as economic theory would predict, it was a period of unprecedented economic growth when the US became the largest economy in the world both in terms of absolute and per capita output. The financial crisis of 1907, where total output fell as much as 10 percent in six months (a much deeper recession than the current

one) (Walton and Rockoff, 2010), was met with no government intervention. Although the short-term hardship was intense, a strong recovery was well under way within a year of the crisis. The only long lasting recession of the period, from 1893-1896, was lengthened by government currency manipulations. The Congress and presidential candidates of the time were pursuing a policy to re-monetize silver that ended up causing steep and sudden inflation. The ensuing financial crisis had characteristics similar to the current financial debacle (Walton and Rockoff, 2010).

Capitalism is not dead; within the last 30 years, the application of capitalist principles has raised over 400 million Chinese out of poverty (Cukier and Klein, 2009). The financial crisis of 2008 is not a failure of free markets, but a failure of government and a stunning example of the unintended consequences of government economic intervention.

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Why America needs Canadian Oil

Mark Milke

In a recent book on women's rights in the Middle East and North Africa, one contributor, who analyzed Saudi Arabia, concluded that nation "remains a country without the basic freedoms necessary for civil society to take root." Eleanor Abdella Doumato chronicled the Saudi prohibition

on political parties, the lack of free speech, restrictions on the media, religion, and assembly, the illegality of trade unions, and the severe restrictions on women's rights (Doumato, 2010: 20).

Over in Russia, Amnesty International noted how, in 2010, "human rights defenders and independent journalists



Suncor

In 2011 millions of protesters took to the streets in the Middle East

continued to face threats, harassment, and attacks.” Amnesty pointed out that “freedom of assembly and expression continued to come under attack, including through the banning of demonstrations, their violent dispersal, and the prosecution of individuals under anti-extremism legislation” (Amnesty International, 2011: 270).

Those two countries are the world’s top two oil producers and exporters, but they’re hardly an exception among oil-rich countries. In fact, most major oil producing and exporting jurisdictions score poorly on a variety of civil, economic, and political rights.

Combining oil export data with measurements from Freedom House, a US-based think tank that tracks a variety of liberties, I found that Canada is one of only two countries among the world’s top 15 net oil exporting countries considered “free” in Freedom House’s comprehensive freedom ranking. (Norway is the other.) (Milke, 2011: 19-20).

Three countries—Kuwait, Nigeria, and Venezuela—are classified as “partly free.” However, fully two-thirds of the world’s top 15 net oil exporters are classified as “not free”: Saudi Arabia, Russia, Iran, United Arab Emirates, Angola, Algeria, Iraq, Libya, Kazakhstan and Qatar (Milke, 2011: 19-20).



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Canada is now America's biggest oil supplier



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Americans in particular should take note. The rhetoric about the need for American energy independence notwithstanding, the trend for US oil imports has been up for decades. The only exception has been in recessionary years. Almost four decades after the 1973 oil embargo imposed by some Middle Eastern countries, an event that first put Americans

on notice oil imports should not be taken for granted. The US now imports 5.5 million more barrels daily than it did in 1973 (US Energy Information Administration, 2011).

That's one reason for Americans to think soberly about where their oil originates. Here's another: the link between a poor human rights

record and instability. The recent Arab Spring uprisings in Tunisia, Egypt, Syria, Bahrain and oil-exporting Libya, among others, are instructive examples. Governments that repress their populations, in addition to being morally problematic, are hardly reliable allies or exporters.

It's not that Americans should necessarily boycott oil that originates in freedom-restricting countries. No nation is perfect on civil, political, and economic rights, and some may be in the process of improvement.

But given US dependence on imported oil, Americans should more clearly understand who

their human rights-respecting friends are and the consequences of any artificial restrictions on Canadian oil imports.

For example, in 1979, the year of the Iranian revolution during which American diplomats were taken hostage in Iran, Canadian oil constituted just 6.4 percent of all US oil

imports. That was similar to Iran's share in the year just before the revolution (6.1 percent in 1978). Imports of Iran's oil were cut in half in 1979 and stopped altogether in 1980 (US Energy Information Administration, 2010; calculations by author).

Since then, while the importance of other nations to the US oil import market has fluctuated, Canada's crude has mattered even more.

By 2009 (the last year with comparable data available), Canada accounted for 21.2 percent of all oil imports to the United States, and is now America's biggest supplier. That was more than all Persian Gulf countries at 14.4 percent, down significantly from 1979 when Gulf countries accounted for one-quarter of all US oil imports (US Energy Information Administration, 2010; calculations by author).

All of this matters, or should, to American and Canadian policymakers. That's because, as the International Energy Agency forecasts, oil will remain the world's dominant fuel for the foreseeable future. It predicts 99 million barrels in daily consumption by 2035, up from 86 million now. That same agency also predicts that unconventional oil—think Canada's oil sands—will play “an increasingly important role in world oil supply through to 2035, regardless of what governments do to curb demand” (International Energy Agency, 2010; 2).

To wit, Canada is the only major world oil producer with these two qualities and advantages: first, it already exports significant amounts of crude oil to the United States; second, it is stable in part because of its longstanding positive record on civil, political, and economic rights.

Looking ahead, there's a third advantage: Canada has the potential to greatly reduce American dependence on sources of non-North America oil. That reality can help the United States avoid any economic and policy shocks that might result from an over-reliance on countries with unpredictable, and in some cases, undesirable regimes. In short, Canadian oil is in the American national interest.

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Paying for a freer culture

Tim Mak

The burgeoning Sun News Network stirred controversy this summer when anchor Krista Erickson savagely criticized Canadian interpretive dancer Margie Gillis on the issue of arts funding. During a prolonged and contentious debate, the two went head to head on the merits of public arts funding. In particular, Erickson questioned Gillis on why her foundation had received \$1.2 million from the government over 13 years.

The segment led to an outcry from viewers outraged at the tone Erickson took with Gillis, although many undoubtedly also shared Gillis' support for arts funding. The Canadian Broadcast Standards Council received so many complaints that it asked the public to stop sending messages because of how overwhelmed they were by the response (Canadian Broadcast Standards Council, 2011).

Public funding of the arts seems quite popular, at least judging from the reaction of viewers angry about the

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Playwrights, dancers, poets, and all other types of artists are seeing their grants reevaluated

television segment. Even so, the issue of taxpayer-funded arts grants is a topic that deserves examination, especially in this time of economic uncertainty and distress.

Government funding for the arts has come under renewed scrutiny in the wake of a global economic downturn. With politicians at all levels seeking to trim their budgets—anywhere, even by small amounts—playwrights, dancers, poets, and all other types of artists are seeing their grants reevaluated.

In the United States, where the recession is hitting particularly hard, 31 states cut their arts budgets for the 2012 fiscal year, part of a trend that has seen arts funding drop 42% over the last decade (Pogrebin, 2011). In Britain, the publicly-funded Arts Council of England announced earlier this year that it would be cutting off grants worth £19.1 million (around CA\$30 million) to 206 organizations (Arts Council, 2011).

In contrast, Canada's federal Conservative government has been less willing to take on



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the issue of arts funding. The Canada Council for the Arts, a publicly-funded agency, had total expenditures of nearly \$200 million in their 2009/2010 cycle, with the vast majority of money going to grants, awards, and prizes (Canada Council, 2011). "Canada is the only country in the G8 that made a decision—not to cut, not to maintain—but to increase funding for culture during the recession," noted

Heritage Minister James Moore in an interview with CBC radio (Q Blog, 2011).

But why should the government reduce funding to arts and culture? For starters, many of the projects currently funded by the government could be done privately, meaning less cost to taxpayers—many of whom will not be able to take advantage of the grants.



Canada is the only G8 country to increase funding for culture during the recession

For example, take a look at the controversy stirred up recently by the government's decision not to award a \$45,000 grant to the SummerWorks theatre festival in Toronto this year. In 2010, the Prime Minister's Office (PMO) expressed its disappointment that the festival had chosen to present a controversial play about a Canadian terrorist. This year, the government announced that the five-year relationship that they had maintained with the festival would not be continuing.

Threatened by the loss of the grant, which represented about 22% of its operating budget, SummerWorks made an effort to bridge the gap through fundraising. By appealing for help, the festival managed to raise \$34,000 in just two weeks (Salerno, 2011). The fundraising drive, along with a \$5 surcharge on tickets, put the festival on solid financial footing (Salerno, 2011). This shows us two things: that publicly funded projects can often be funded privately, and that people are willing to pay for culture.

Since this is the case, why should a taxpayer in Kamloops, British Columbia, be responsible for the burden of paying for a theatre festival in Toronto? Or vice-versa? The costs of public funding

weigh even heavier still when one considers that Canadian debt is projected to exceed \$600 billion by the 2012/2013 fiscal year (Government of Canada, 2011).

In addition, some have suggested that the Prime Minister's Office influenced the Heritage Ministry's decision not to award the grant, citing the PMO's objections to the controversial play that it had held last year. This has not been conclusively determined, but whether or not this is the case, the possibility alone suggests that public arts projects are more easily censored.

A more clear-cut case of public arts funding leading to censorship is one involving the National Portrait Gallery in the United States. When the gallery, administered by the Smithsonian Institution (which receives federal funding), sought to present an exhibit with a video of ants crawling over a crucifix, a public outcry ensued. Amid criticism from House Speaker John Boehner, the gallery pulled the item from the exhibition (Starr, 2011).

This illustrates how public arts projects are more easily censored than privately funded ones. When everyone—every taxpayer—is responsible for funding an art project, everyone is a stakeholder, which means that anyone could have a legitimate grievance about how their money is being used inappropriately.

Indeed, government funding has a chilling effect on the recipients of grants—in hopes of avoiding widespread outcry and the loss of funds, recipients may feel pressured to produce less controversial work. Of course, this is bad for the arts—plays, paintings, and pictures should be able to offend, and even inspire undesirable reflection on the part of the audience.

A common criticism to this point is the government should simply ignore public objections to controversial, publicly-funded art, that putting constraints on the nature of public art projects is tantamount to challenging the freedom of speech. Nothing could be further from the truth. One may have the right to put on whatever play they choose, but one does not have the right to use other people's money to do it. If an artist wants to engage in controversial social commentary, he or she can do so with funding from those who actually support the cause—and without dragging everyone else along for the ride.

To be sure, private funding for the arts sidesteps this problem. If you find something deserving of attention, then you can purchase

Controversial art can be vulnerable to censorship through government funding cuts



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that book, or pay a visit to that museum, or pick up tickets to that play. If you find images of ants crawling all over a crucifix objectionable, then you can skip that exhibit entirely.

In addition, one final point: why should the government—or publicly funded bodies, in any case—choose what art projects should be elevated, and which should be rejected? There is no evidence that federal bureaucrats are better able than proprietors of the arts to determine what makes for “good” art, especially since cultural tastes vary by individual and region. Canadian culture and the arts would be

better served by letting those who enjoy the arts and are willing to pay for those enjoyments choose the projects that are worthy.

Private funding for the arts encourages those who enjoy the arts to pay their full and fair share, while freeing taxpayers from the burden of supporting projects that they neither need nor can enjoy. Further, shifting the responsibility for funding culture from the public sector to the private sector removes the chilling effect that government grants can have on creativity. Finally, proprietors of the arts know better than the federal government what constitutes good art and should be allowed to decide which projects are supported. In a time of economic uncertainty and a rising debt, Canada needs to seriously rethink the amount of public funds that are going to support art projects.

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Short Selling

A free market alternative for exposing foreign corporate fraud

Mark McGinley

In order to ensure the integrity of the financial markets and the continuance of investor confidence, it is crucial that foreign corporate fraud be rooted out and eliminated. The question then becomes, who is most capable of achieving this objective: the public or private sector?

As the US economy continues to struggle out of the Great Recession, public sentiment is shifting to favour increased government regulation of the financial markets, and a tightening of auditing requirements to prevent corporate fraud (MyBankTracker.com, 2010). While this approach may successfully reduce instances of domestic fraud, US government regulation is less able to address the problem of corporate fraud perpetrated by foreign companies trading on US exchanges. US regulators

are constricted in their ability to investigate foreign fraud because they are required to liaise with the foreign company's home regulator—a regulator that may be unresponsive, corrupt, incompetent, or outright hostile (Rahn, 2008). As a result, US regulators can have a difficult time getting the information required to conduct their investigations.

Instead of looking to expand the scope and power of US regulators, perhaps we can look to the private sector for innovative solutions that can help maintain the integrity of our financial system. One such solution can be found by enlarging the role that short sellers play in uncovering and punishing foreign corporate fraud. To understand how short sellers can act to uncover and punish foreign corporate fraud in the marketplace,



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and how they could be able to do so more effectively than US government regulators, let's look at an example provided by the noted short seller, Muddy Waters LLC.

The mechanics of short selling

Before explaining the role short sellers can play in uncovering and punishing foreign corporate fraud, it is important to understand what short selling is and how it works. Basically, short selling is the counterintuitive act of buying high and selling low; in essence, it is betting against the market. Here is how it works: a short seller (shorter) decides that a particular stock is overvalued, perhaps because they think the company is headed for a bad quarter, or they suspect that the company is engaged in fraudulent activity. To initiate the short, the shorter approaches a lending institution, which agrees to lend the shorter a certain number, let's say 100, shares of that company's stock, typically charging them a lending fee. The shorter agrees to give back the 100 shares at a later date. Immediately after borrowing the shares, the shorter sells them at the current market value, let's say \$100 per share, and pockets the proceeds. Following the sale, the shorter waits to see if the share price will fall to reflect what they consider to be the actual value of the shares. Let's say that the share price falls from \$100 to \$50 two weeks after the

sale. In this scenario, after having made \$100 per share, or \$10,000, in the initial sale, the shorter is able to buy back the 100 shares owed to the lender for \$50 per share, or \$5,000. The shorter's net profit from the endeavor is thus \$5,000. However, if the share price rises during that time, the shorter is forced to buy back the shares owed to the lender at a price higher than that received in the initial sale, resulting in a net loss.

Now that the basic mechanics of short selling are clear, let's look at Muddy Waters and how they are using short selling to punish foreign corporate fraud in the marketplace.

The Muddy Waters approach

The short selling conducted by Muddy Waters focuses on privately held Chinese companies that purchase publicly traded American companies to gain access to highly coveted American stock exchanges, like the New York Stock Exchange. These types of purchases are called reverse takeovers (RTOs). They are called reverse takeovers because in an RTO a private company is taking over a publicly held company, whereas in a typical takeover a publicly held company would be acquiring a private company (Investopedia, 2011). Aware of the potential for fraud in Chinese RTOs, Muddy Waters utilizes an extensive network of investigators and analysts, both in the US



US regulators are constricted in their ability to investigate foreign fraud

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and China, to examine companies suspected of fraudulent activity. In cases where fraud is uncovered and confirmed, Muddy Waters responds by shorting the company's stock. As described above, this means borrowing the company's stock from a lender and then immediately selling it at market value. After shorting the stock, Muddy Waters releases a comprehensive report detailing their allegations against the company, as well as the evidence that it has accumulated in support of the charges. In response, the company's stock price begins to decline. Once it reaches the price level anticipated by Muddy Waters, they then repurchase the stock at the new lower market price and deliver the borrowed shares back to the lender, effectively "closing" the short sell and making a tidy profit in the process.

Now that the mechanics of short selling and the Muddy Waters approach have been

explained, let's discuss why short sellers using the Muddy Waters approach can be more effective at uncovering foreign corporate fraud than US regulators, and how short sellers themselves can be prevented from committing the very type of fraud they are supposed to be punishing.

Why short sellers are better able to investigate foreign corporate fraud than US regulators

When it comes to investigating foreign corporate fraud, short sellers using the Muddy Waters approach have a number of advantages over US government regulators. By virtue of their status as private organizations, short sellers are able to bypass a substantial amount of bureaucratic red tape when making information requests of foreign regulators, thus enjoying quicker access to information than US regulators (Rahn, 2008). Further, private companies are able to visit and covertly investigate the asset holdings of foreign companies with greater ease than US regulators. Indeed, Muddy Waters researchers were able to enter China easily and directly investigate asset holdings without political interference. Contrast such direct access with the official avenues of inquiry the US Securities Exchange Commission (SEC) must follow, which require liaising with foreign

regulators that may be uncooperative, corrupt, or outright hostile (Rahn, 2008). Further, private short sellers are able to reap immense profits from successful fraud allegations, allowing them to offer lucrative compensation to their researchers and analysts, which can far exceed the salaries offered by government regulators. This competitive edge helps enable them to recruit and retain top talent. Moreover, a short seller's private sector status allows them extensive discretion and flexibility in designing their own incentivizing compensation plans to encourage a high level of performance amongst researchers and analysts. Imagine the performance gains that could be realized if the SEC were allowed to compensate investigators with a percentage of the total dollar amount of fraud that they uncovered; presumably, investigators would be more motivated to work to expose fraudulent activity just as commissioned salespeople are more motivated to make a sale.

With all of these advantages over US government regulators, short sellers using the Muddy Waters approach have the potential to be very effective at uncovering and punishing foreign corporate fraud.

Private fraud investigators can enter China without political interference



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However, this approach also carries with it the potential for abuse. Let's look at how short sellers can operate to defraud the market and the safeguards that could be put in place to ensure that short sellers do not negligently or fraudulently accuse companies of wrongdoing for their own gain.

Deterring and punishing fraudulent short selling

Under the US Sarbanes-Oxley (SOX) legislation, the SEC is required to publicly disclose any

US courts have already demonstrated a willingness to punish fraudulent short sellers

formal investigations conducted regarding corporate fraud, making a decline in stock price inevitable for the company under investigation (Pollock, 2006). Short sellers are aware of this requirement for disclosure and, as a result, there exists a serious concern that a short seller could target a company, short their stock, release a report containing unfounded allegations of fraud, and make a substantial profit upon the launch of a formal SEC investigation. By using such “short and distort” practices, the shorter is seeking to purposely manipulate the market using false information (Pollock, 2006). In this scenario the targeted company could be completely innocent and yet the short-seller would still make money off the deleterious effect the investigations would have on the company’s stock price.

There are, however, a few safeguards in place to deter this type of fraud. The legal system should act as a significant deterrent to unscrupulous short sellers by providing falsely accused companies with opportunities for redress. If a short seller were to release a report containing allegations of fraud that turned out to be unfounded, the people responsible for preparing and issuing the



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report could be charged, both criminally and civilly, with committing fraud (Frenkel, 2011). The wrongfully accused company could also seek redress by suing the short seller for securities fraud, defamation, slander, and tortious interference with contracts (Frenkel, 2011). US courts have already demonstrated a willingness to punish fraudulent short sellers. In 2004, short seller Anthony Elgindy was sentenced to 11 years in prison for generating fraudulent information about a company which he then released to lower the stock price for his own gain (Dash, 2004).

While the legal system may prove effective in providing recourse for the wronged company, it is certainly preferable to prevent the company from being wronged in the first place. Alex J. Pollock, former president and CEO of the

Federal Home Loan Bank of Chicago, offers a solution to this dilemma. He recommends that SOX be amended to “[r]equire that any party bringing claims of accounting or financial irregularities to the SEC publicly disclose all the short or long financial interests it

has or represents in the company it is accusing” (Pollock, 2006). Should this requirement be implemented, the market would be able to weigh the allegation of fraud against the profit the party making the allegation would stand to make if the claims were true. This approach would introduce substantially more transparency into the market, allow the market to weigh the credibility of the accused company and the accusing short seller respectively, and decrease the potential for market manipulation.

Conclusion

US regulators are not well equipped to investigate foreign companies trading on US markets. By virtue of having to deal with foreign regulators who may be hostile,

uncooperative, or incompetent, US regulators will often have a difficult time getting the information they require to investigate foreign companies suspected of fraud—if they can get it at all. Instead of working to create large, bureaucratic, international regulators, or expanding the power and scope of US regulators, we should be encouraging short sellers to take an active role in uncovering and punishing foreign corporate fraud.

As private sector entities, short sellers following the Muddy Waters approach are free from the bureaucratic and regulatory restrictions that constrain domestic government regulators. As a result, short sellers may be more effective at discovering fraud perpetrated by foreign companies. Moreover, their workforces can be compensated and incentivized to a much greater extent than government regulators, which may result in a higher level of employee performance.

While the government will continue to regulate the markets within its jurisdiction, it is clear that government regulators have some limitations when attempting to regulate companies that trade on its stock exchanges but conduct their operations in foreign countries. To address fraud perpetrated by foreign companies, we should call upon the private sector, and specifically short sellers, to fill the regulatory void that domestic regulators are unable to fill themselves. Short sellers

can complement the work being done by government regulators by illuminating the darkest corners of the market, the corners that government spotlights are unable to efficiently reach. We should be encouraging short sellers to act in concert with domestic government regulators, each making the other stronger, and both making our markets safer and more trustworthy.

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Regulation and the Canadian auto insurance market



M. Emrul Hasan

Auto insurance can be imagined as a large pool into which drivers put their money as premiums. Funds from this pool are then used to provide compensation for the losses suffered during auto accidents through claims and for

the expenses of running the auto insurance business. Automobile liability insurance is mandatory for all drivers throughout Canada. This insurance provides financial protection for drivers who are held responsible for injury or loss sustained by others as a result of the

action of the driver's vehicle. This automobile insurance coverage and the range of benefits vary widely from one province or territory to another. In British Columbia, Saskatchewan, and Manitoba, government run insurers¹ provide the basic mandatory auto insurance

Severe regulation creates high costs for insurers

policy, and compete for the sale of optional² insurance coverage with private companies. Quebec's public insurer runs a monopoly on personal bodily injury auto insurance that covers damages to a victim's own body, but does not compete with the private sector for the sale of property damage coverage, which covers a victim's vehicle and other assets. Private insurers provide all the automobile insurance supplied in six other Canadian provinces: Alberta, Ontario, New Brunswick, Nova Scotia, Prince Edward Island, and Newfoundland & Labrador. Each provincial government sets its own standards and its own minimum limits for the amount of liability coverage that drivers must buy (IBC, 2009).

Automobile insurance is compulsory in Canada, which raises concerns about its affordability. High auto insurance rates, mostly in Ontario and British Columbia, have long been a source of anger for drivers. To combat the perceived high cost of auto insurance, different



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provincial governments have passed a variety of premium rate setting regulations, with varying levels of severity, and these rate control regulations are often introduced in conjunction with changes to product design and coverage mentioned above. The provincial and federal regulators claim that the primary objective of these regulations is to keep premium prices within the means of Canadian drivers. Are these regulations justified if they can reduce the burden for consumers of high premiums while meeting regulatory objectives, or is the affordability of Canadian auto insurance greatly compromised by regulatory severity?

by both federal and provincial governments. The federal Office of the Superintendent of Financial Institutions (OSFI) is concerned primarily with the solvency (financial health) of private insurance companies that are registered under federal statutes. This includes capital requirements that serve as a cushion against unexpected losses.

Provincial regulators (e.g., the British Columbia Utility Commission (BCUC) in BC) govern the rate regulation and mandatory minimum coverage laws. Depending on the province, regulators may oversee how insurance

The regulatory landscape in Canada

Both private and government-owned auto insurers in Canada are extensively regulated in the form of rate setting restrictions, mandatory minimum liability and accident benefits laws, solvency laws, etc. Insurers are regulated

companies assess risk, determine prices, and handle claims. Provincial regulators actively determine which factors insurers can and cannot use when setting auto insurance rates. A driver's age and gender may be considered in certain provinces, for example, but not in others. Insurers must have their risk classification system approved by provincial regulators and must also receive government approval any time they want to change their rates.

There are also differences in mandatory minimum coverage across provinces. Each determines which types of insurance protection are mandatory or optional for all vehicles and also sets minimum liability limits. For example, in 2009, the compulsory minimum third-party liability coverage was \$200,000 in every province except in Quebec and Nova Scotia where drivers were required to have minimum third-party liability coverage of \$50,000 and \$500,000 respectively (IBC, 2009). Insurers design their products according to these coverage regulations. Some provinces permit people to sue for pain and suffering and for economic loss above and beyond their insurance benefits, but set limits on these payments.

What are the objectives of these regulatory regimes? One primary objective is to combat high premium costs. According to the regulators, rate regulation is necessary to reduce premium price variation across drivers, and specifically to reduce premium price levels for high-risk drivers who are more prone to accidents (Derrig and Tennyson, 2008). It has also been claimed that rate regulations create "efficiency" by subsidizing insurance rates for some drivers who might otherwise drive without any insurance (Keeton and Kwerel, 1984).

Is the current regulatory environment working for Canadians?

Most of the regulatory objectives are highly controversial and do not stand up well under the scrutiny of empirical research and economic theories. According to the empirical studies, most regulations aimed at reducing premiums are unnecessary and overly

burdensome, thus suggesting that greater and more intrusive regulation is counterproductive.

Several studies done on US states and Canadian provinces argue against the regulatory severity in the Canadian auto insurance market. Skinner and Rovere (2010) found that compared to US states, Canadian provinces have severe regulations in the auto insurance sector. The study measured regulatory severity in 60 jurisdictions in the US and Canada and concluded that Ontario, Manitoba, British Columbia, and Saskatchewan have the most severe auto insurance industry regulatory regimes. Interestingly, drivers in these four provinces pay some of the highest premiums in Canada (Skinner, 2008).

Regulations that reduce premium price levels for high-risk drivers discriminate against better drivers by transferring cross-subsidies from low-risk drivers to high-risk drivers (Derrig and Tennyson, 2008). This cross-subsidization can conceivably reduce premiums for high-risk drivers while low-risk drivers pay higher premiums than they would otherwise if premiums were based on risk. As a result, high-risk drivers who receive subsidies are more likely to purchase insurance while low-risk

Consumers should be able to choose the insurance they need



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drivers who are charged higher prices may be less likely to participate in insured activities. This can potentially create an adverse selection problem in the insurance market by having more high-risk drivers and less low-risk drivers.

A moral hazard problem can also arise if cross-subsidization reduces the links between insurance risk and insurance prices, thus creating lower rates for high-risk drivers. When rates for high-risk drivers are lower than necessary to cover losses, the result is the encouragement of riskier driving behavior. Clearly, rate regulation is not meeting the regulatory objective of reducing the burden for drivers of high premiums.

What about solvency and minimum mandatory coverage regulations? Some sort of solvency regulation is desirable to protect consumers. However, overly stringent solvency requirements can reduce profitability and adversely affect the policyholders, as it can force auto insurers to withdraw money from high performing assets and instead invest in low performing assets (SRCL, 2011). This can reduce the investment return of insurers, which they use as a cushion against rising claim costs.

Kelly and Li (n.d.) found that if stringent rate control is introduced in conjunction with changes to product coverage—which has been a case for varying mandatory coverage systems

in Canada across provinces—it forces insurers to redesign their products, which can also lead to increased costs.

Conclusion

The findings clearly show that tougher regulations in Canada are actually making auto insurance more unaffordable. Rate regulations create high costs for insurers via moral hazard and adverse selection. If solvency regulations become onerous, they can cause investment returns to go down. At the same time, mandatory minimum coverage regulations raise the product redesign costs and hinder insurer innovation. These will all lead to higher costs for insurers, and consumers will pay for these costs through elevated premiums.

Premium prices can be determined either by competitive pricing, where market forces set the price through effective competition among a large number of players, or by regulatory pricing where regulators set the prices through different levels of rate setting and product design regulations. The latter clearly doesn't work. Then what policy will benefit consumers? Leadbetter et al. (2004) suggested using competitive pricing in auto insurance settings. Their empirical study found that premium

volatility in Ontario began increasing following the introduction of rate regulation in 1989. Prior to this, unexplained volatility in Ontario's automobile insurance premiums was less than for Alberta and the Atlantic provinces, which operated with rate regulatory regimes while Ontario allowed prices to be determined by market forces. Therefore, scaling back regulatory severity and allowing prices to be determined by market forces will benefit consumers. Empirical evidence and economic principles suggest that as long as prices are determined by competition rather than by rate regulation, solvency is appropriately regulated (see Harrington, 1991) and consumers have the freedom to choose the kind of auto insurance they need, and we should expect to observe lower premiums in Canada.

Notes

1 The government-run monopolies are the Insurance Corporation of BC (ICBC), Saskatchewan Government Insurance (SGI), and Manitoba Public Insurance (MPI). In Quebec, the government-run insurance body is Société de l'assurance automobile du Québec (SAAQ).

2 These are collision insurance that covers damages to a driver's own vehicle as a result of an impact with another vehicle, object, or person, and comprehensive insurance that covers damages caused by fire, theft, vandalism, etc. This coverage is not mandatory.

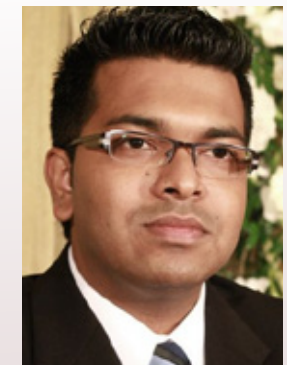
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Canadians wait more than two-and-a-half years for governments to approve new medicines

Federal and provincial government bureaucracies are taking more than two-and-a-half years on average to approve new prescription drugs, thereby depriving many Canadians of the latest in new medicines, finds a new report from the Fraser Institute.

“On average, it takes Health Canada nearly 16 months to approve new drugs as safe and effective. After that, the provinces typically spend another 15 months or more deciding whether new medicines will be eligible for public reimbursement under provincial drug plans,” said Mark Rovere, the Fraser Institute Associate Director of Health Policy Studies.

The study also found that only 23 per cent of new drugs approved as safe and effective by Health Canada in 2004 had been approved for either full or partial reimbursement under provincial drug plans as of June 9, 2011, compared to 98 per cent that had been covered by at least one private insurer.

[Read the complete report](#)



Why does the BC government want to ban pesticides that have the same risks as pickles and cell phones?

The busybody tendencies of BC politicians are leading to the further regulation of what had previously been the refuge of green thumbs across the province: green lawns, colorful flower beds, and ripening vegetable gardens.

As of early July, the BC government has been reviewing the feasibility of further regulating your private garden by adopting ill-conceived laws restricting pesticide use that do not accurately reflect the current state of scientific knowledge. A hasty ban on the cosmetic use of artificial pesticides should not be implemented until the underlying science is conclusive and a comprehensive analysis of the potential side effects resulting from the ban has been undertaken.

By banning pesticides for cosmetic uses, BC would be following the questionable precedent set by several other provinces.

[Read the complete op-ed](#)

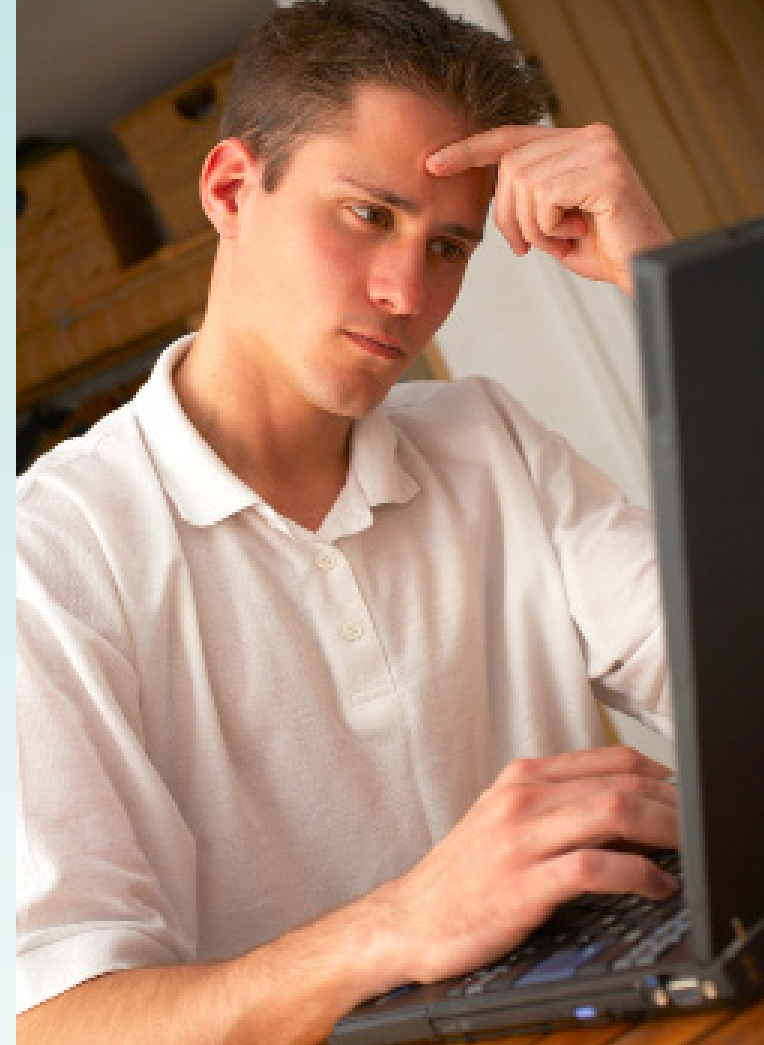


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