The positive contributions of small international financial centres
Informing the global debate

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Trillions of dollars flow annually through small International Financial Centres (IFCs), such as the Cayman Islands, Luxembourg, Jersey, the British Virgin Islands and Bermuda. The vast majority of these flows are not invested directly in these small IFCs, but rather are aggregated and channeled into investments across the globe.

Such flows exist in large part because these small IFCs, constrained by their small landmass as well as an absence of natural resources and other economic factors of production, have successfully focused on the development of efficient and responsive regulatory environments that best match the preferences of rational and sophisticated consumers of financial services.

These specific attributes of efficiency and responsiveness provided by such small IFCs incorporate legal and commercial certainty as well as relatively low-cost tax-neutral platforms designed to facilitate connections between and among sources of capital and entities which use capital. Such platforms serve to reduce the cost of credit intermediation and facilitate mechanisms for efficient capital structuring thereby lowering capital and risk mitigation costs. The reduced cost of capital along with less expensive risk mitigation, allows for more capital to be applied to innovation, entrepreneurship and job creation on a global basis. The allocative efficiency benefits provided by small IFCs ultimately serve the interests of all.

However, small IFCs have made relatively little effort to inform the global discussion on the important benefits they provide, and in this vacuum, periodically the policy narrative emanating from the G-20/EU jurisdictions has been critical of the role small IFCs play in facilitating the efficient cross-border flow of capital. This article is intended to provide an introduction to the ongoing contributions of small IFCs to the global financial architecture.

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The integration of small IFCs with G-20/EU jurisdictions

The evolution of small IFCs has been an iterative process with a critical role being played by private sector actors, including both professionals and multinational financial institutions. These private sector actors in small IFC jurisdictions are interconnected and integrated with, and in some cases identical to, those in the G-20/EU jurisdictions. They include the Big 4 accounting firms as well as lawyers, bankers and other finance professionals. Indeed, the professionals in major IFCs are often pivotal in the identification of opportunities for regulatory symbiosis between small IFCs and G-20/EU jurisdictions. These professionals are also often instrumental in the development of the legal and regulatory frameworks required to provide an operational 'coupling' between small IFCs and G-20/EU jurisdictions.

Due to homogeneous regulatory preferences, private sector players may be expected to aggregate in the particular localities that best match their preferences. This observation may be viewed as a corollary of 'path-dependence' in the context of homogeneous regulatory choices, in which the actions of first movers increase the likelihood that later movers will make the same choices.[1] By doing so, such actors bring an added element of economies of scale to the chosen locality, which may in turn strengthen such preferences.[2]

The proficiencies generated in small IFCs create the potential for global benefits in the form of greater access to capital, reduced risk and lower capital costs[3]

1 *WB Arthur, Increasing Returns and Path Dependence in The Economy (University of Michigan Press, Ann Arbor 1994) 33; B Reszat, 'Evolution, Spatial Self-Organisation' (2000) Hamberg Institute of International Economics HWWA Discussion Paper 93 <http://opus.zbw-kiel.de/volltexte/2003/690/pdf/93.pdf>; MP Hampton and J Christensen, 'Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance' (2002) 30 World Development 9*

2 *Economies of scale may be attributed, in part, to the fixed cost of the regulators and service providers being spread over an increasing number of consumers, which generates market efficiencies for each consumer*

Accordingly, if it is assumed that these private sector actors have acted rationally, it then follows that in relation to the basket of factors, including laws and regulations which influenced the selection of such small IFCs, these small IFCs provide the closest match to the preferences of these actors.

By way of example, the Cayman Islands evolved as the jurisdiction of choice for domiciling hedge funds. Bermuda evolved as the jurisdiction of choice for reinsurance. The British Virgin Islands evolved as the jurisdiction for International Business Corporations (IBCs). Each jurisdiction developed a particular area of specialisation and therefore became proficient in that domain.

The global benefits generated by small IFCs

The proficiencies generated in small IFCs create the potential for global benefits in the form of greater access to capital, reduced risk and lower capital costs.[3] By way of example only, hedge fund operators seeking to attract global investors and even the best managers may rationally seek to align the location of hedge fund activities with these preferences. The preference exhibited by hedge funds for jurisdictions such as the Cayman Islands perhaps provides evidence of a 'race to the top', best matching investors' interests in terms of efficiency and return on investment. Indeed, the IMF assessment of small IFCs found that on average, small IFCs have been ***more favourably regulated***.[4] Along the same line, the research of Professor Liang from the University of Massachusetts Amherst indicates that offshore hedge funds provide a higher illiquidity premium.[5]

Similarly, a study by Professor Desai, Foley and Hines from the Universities of Harvard and Michigan, demonstrated that investors in hedge funds domiciled in offshore jurisdictions attained a higher return on investment, supporting the claim of the 'offshore effect'.[6] The latter research also indicated that there was an additional complementary relationship between small IFC entities and their major IFC affiliates in that the use of small IFCs stimulated 0.5% to 0.7% growth in investments and sales in nearby major IFCs.

By way of further example, the 2007 U.S. Senate hearings reported that the endowments of many high profile educational institutions in the U.S. have a significant portion of their portfolios in offshore hedge funds.[7] More specifically, an average of 22% of American university endowment portfolios are invested in hedge funds, many of which are domiciled in small IFCs.[8] The returns on these endowment portfolios have facilitated Ivy-league universities, such as Harvard, in providing more scholarships to academically capable students from economically poor backgrounds.
From the point of view of the student receiving the scholarship, small IFCs have undoubtedly provided a benefit. Furthermore, in the context of the EU, Professor Hertig from the Swiss Institute of Technology has observed, paying special attention to the domicile of collective investment funds, that the tax-saving resulting from registering such funds in Luxembourg rather than in the member state in which they are distributed, brings efficiency benefits to the EU.[9]

3 CW Calomiris and RE Litan, 'Financial Regulation in a Global Marketplace' (2000) Brookings-Wharton Papers on Financial Services <http://muse.jhu.edu/demo/brookings-wharton_papers_on_financial_services/v2000/2000.1calomiris.pdf>

4 IMF, 'Offshore Financial Centres: The Assessment Program – An Update', 7 (2004) <http://www.imf.org/external/np/mfd/2004/eng/031204.pdf>.

5 B Liang and H Park, 'Share Restriction, Liquidity Premiums and Offshore Hedge Funds' (2007) Financial Management Association International <http://www.fma.org/Orlando/Papers/Offshore_20070116.pdf>

6 Desai, CF Foley, and JR Hines Jr., 'Economic Effects of Regional Tax Havens' Ross School of Business Working Paper Series Working Paper No. 919 October 2004 <http://sambuca.umdl.umich.edu:8080/bitstream/2027.42/39179/1/919.pdf>

7 JG Gravelle, 'Statement before The Committee on Finance, United States Senate – September 26, 2007 – On Offshore Tax Issues' <http://www.senate.gov/~finance/hearings/testimony/2007test/092607testjg.pdf>

8 ibid

9 G Hertig, 'Regulatory Competition for EU Financial Services' in DC Esty and D Geradin Regulatory Competition and Economic Integration: Comparative Perspectives (Oxford Oxford University Press, Oxford 2001) p. 228

Why not in G-20/EU jurisdictions?

This raises the question of why these capacities and innovations are not implemented in the major IFCs and G-20/EU jurisdictions. The answer would appear to relate to the complexity and competing interests of the politics of G-20/EU jurisdictions. The Noble Laureate, Joseph Stiglitz, observed that all taxes either direct or indirect, distort economic behaviour and cause 'deadweight' losses.[10] This distortion may become more pronounced when the same goods or activity are subject to such losses at different rates in different jurisdictions.[11] This is perhaps best summarised by Professor Shaviro from the University of Chicago, who explains: *"When there is trade across jurisdictional boundaries, each jurisdiction may be inclined to impose tariffs burdening imports. This tends to be generally inefficient; since it results in deadweight loss by inducing consumers to substitute locally produced goods for those they would have preferred if not for the differential tax treatment. Gains from trade across jurisdictional boundaries by people with different areas of comparative advantage are therefore lost [...] the opportunity to create gains through trades without being impeded by tariffs is* ***a kind of public good****, the scale of provision of which is the entire trading area.[12]"*

By way of example, U.S. tax-exempt investors such as pension funds, other retirement funds, university endowments and other private foundations are generally not subject to taxation. However, tax obligations may arise for an investor in this class if it invests in a hedge fund that has income classified for U.S. tax purposes as 'Unrelated Business Taxable Income' (UBTI).[13] The unintended consequence of this rule is that now U.S. tax-exempt investors frequently choose to invest in offshore affiliates of U.S. hedge funds that are organised as corporations, which under US taxation rules are not pass-through structures and therefore do not create a risk of UBTI.[14] In this regard, the interests between small IFCs and G-20/EU jurisdictions may be viewed as aligned and, relative to major IFCs, small IFCs may provide the regulatee with tax and regulatory products that are better matched to the particular activity, and consequently afford benefits, or at least the possibility of limiting 'deadweight loss'. Moreover, given the many competing interests in large jurisdictions, legislators in major IFCs may be less concerned with limiting the unintended 'deadweight' economic losses of particular regulatees than they are with other issues.

Articulation and dissemination of the positive role of small IFCs

Notwithstanding, the evidence that the economic interests of small IFCs and those of G-20/EU countries are aligned, (as further illustrated by the fact that multilateral agencies controlled by G-20 governments, as well as large international businesses based in such jurisdictions, routinely make use of the available efficiencies afforded by small IFCs), from time to time policy narratives critical of small IFCs emerge particularly when scapegoats are thought to be expedient. Such narratives are generally supported by no academic basis or less than fully informed academic opinion which denies any contribution to economic efficiency or global welfare by small IFCs. The paucity of refuting academic and practitioner literature together with the lack of any effective communication of the evidence available permits an ongoing threat to the very existence of small IFCs and the business structures they facilitate.

10 This is generally applicable to all taxes other than lump sum taxes such as head taxes. JE Stiglitz, Economics of the Public Sector (Norton New York 1988) 478-479

11 WW Bratton and J McCahery, 'Tax Competition in the European Union' in DC Esty and D Geradin Regulatory Competition and Economic Integration: Comparative Perspectives (Oxford University Press, Oxford 2001) p. 224

12 D Shaviro, 'Some Observations Concerning Multi-Jurisdictional Tax Competition' in DC Esty and D Geradin Regulatory Competition and Economic Integration: Comparative Perspectives (International economic law series (Oxford University Press, Oxford 2001) 4

13 S Nadel, 'An Accountant's Guide to the Major Legal Issues Affecting Hedge Funds' (1998) The CPA Journal <http://www.nysscpa.org/cpajournal/1998/1098/Departments/D721098.html>

14 ibid; RS Zarin, and WP Zimmerman, 'Overview of Hedge Fund Tax Structures' (2006) 7 Journal of Investment Compliance 1

What then can be done by way of education? The limited academic literature has identified a number of underlying factors which may contribute to the economic efficiency provided by small IFCs, and has also identified a number of correlations that require greater research. However, such information has yet to be either confirmed by appropriate research or translated into professional literature and public awareness. Other areas of research, including research related to the benefits of cost of credit intermediation,[15] simply have not been explored. Although some accounting, legal and finance professionals are aware, at least anecdotally, of the contributions of small IFCs to economic efficiency and global welfare, to date relatively little has been done to compile or disseminate the relevant information to the global accounting or other professional communities. Further, the research required to model how IFCs could maximise their contributions to the international community has not been carried out.

The collection of information on the positive role of small IFCs is critical both to small IFCs and to the professionals and clients which use them. In order for such information to contribute to the relevant debates and to de-bunk the ill-informed narratives against small IFCs, it is necessary for such information to be produced in a compelling format and distributed among those who inform the relevant debates. It is in this context that education, perhaps facilitated by an education trust focussed on fostering robust academic research on the global benefits of small IFCs, could make a significant contribution.

To the **point**:

- The roles and contributions of SIFCs in the global economy are not sufficiently understood
- SIFCs have focused their economic development on providing efficient and responsive financial services that both meet international standards and match the preferences of sophisticated users
- The trillions of dollars that flow through SIFCs are invested in developed and developing countries to the benefit of both the recipients of investments and the investors
- Research has demonstrated that SIFCs offer greater returns on certain classes of investments as a result of what has become known as the 'offshore effect'
- SIFCs are known to offer lower cost credit intermediation, however further research is required to identify mechanisms for optimising such credit intermediation advantages
- Education is required to remedy misconceptions regarding the role and contributions of SIFCs that persist in some circles

15 *Bernanke, B, 'Non-Monetary Effects of the Financial Crisis in the propogation of the Great Depression' (1983) 73 The American Economic Review 3, p 257-276. Bernanke argues that the increased cost of credit intermediation (CCI) serves as an explanatory factor for the unusual length and depth of the depression*