Off-shore financial centres and Small States

Political leaders in the US, Germany, France, the UK and elsewhere have once more threatened to close down off-shore financial centres. These centres have been presented as the drug dealers of modern finance and pushers of instability. Yet the origins of this crisis are a failure of regulatory philosophy in the US, Europe and elsewhere. It would have occurred were there no off-shore financial centres. The attack on off-shore centres is a politically seductive distraction from the thorny task of making regulation better in large developed countries and will end up being a discriminatory attack on small developing countries with little voice.

One of the first institutions to fail in this crisis was Northern Rock, a very British bank where supervisors appeared to overlook the niggling detail that funding long-term mortgages of over 100% of the value of homes in a mature boom, with short-term deposits and money market funds, is highly risky. A German savings institution, IKB, was next. Regulators did nothing about the exponential growth of mortgage-related financial derivatives, not because they were hidden in off-shore financial centres – they had the discretionary powers to raise bank capital charges for any additional risks they perceived - but because they thought that this was an example of safe financial innovation that was banking the under-banked and diversifying risk.

Admitting that the crisis was a failure of domestic regulation implies that those in power were out to lunch as the largest financial crash was brewing. It is easier to blame tax-dodging foreigners. But let us be real. The largest centres of boastfully light regulation and light taxes for non-residents were London, Luxembourg, Dublin, the Channel Islands, Gibraltar, Monaco and many other locations in the European backyard. Yet some G7 leaders would rather play to the gallery by stepping on small developing countries. You can see why international co-operation is struggling to secure legitimacy when the same countries that mucked up their own regulation, plunging the world into crisis, appoint themselves judge and jury of what is good, bad and ugly elsewhere.

There are at least three ways in which the current attack on off-shore financial centres is illegitimate. First, it flies against the notion of tax sovereignty. Europeans prize this internally, but do not want others to have it. Why should developing countries that have difficulties in administering direct taxes, and so rely more on land and consumption taxes, not have low income taxes? And remove tax competition and you remove one discipline on countries otherwise tempted to engage in expensive wars or over-generous government bail-outs.

Second, the idea of off-shore financial centres is that they offer low tax because taxes are paid before money reaches them and after it leaves them. Imagine a company that builds and sells cars in Britain, Turkey and Japan. If the holding company is based in an off-

shore financial centre, corporation taxes on earnings will be paid in the British, Turkish and Japanese subsidiaries before they arrive in the holding company. Taxes on dividends are then paid by the shareholders when they repatriate their dividends home – wherever that maybe. The off-shore centre acts as a “way station” that facilitates complex international trade and investment flows. There are no taxes or low taxes in the “way station” because the money is in transit. Taxes are paid at the beginning and at the end of the journey, just not along the way.

The potential for abuse is whether the way station becomes a hiding spot, either to reduce taxes at the end of the journey, or to launder criminal money. The problem is not the tax rate but Swiss-style bank secrecy. The solution is what Bermuda, Barbados and other responsible off-shore financial centres do, which is to have information agreements that allow tax authorities to share information. The presence of standardized tax information agreements applicable to all countries would be an objective measure of responsibility.

Of the 192 members of the UN, 56 countries and are a further 100 dependent territories have populations of less than 1.5 million. Smallness brings its own challenges and vulnerabilites. International finance is one of their few comparative advantages: it can be scaled up without more land and labour. Many have developed genuine world-class expertise in international financial services such as Bermuda, Luxembourg and Guernsey. The current financial crisis suggests that large states have a comparative disadvantage in global finance. They do not need global finance to prosper, but global finance distorts their economy and politics. There are more than a few small states that need to improve the quality of their regulation, but so too for large states. European and US governments should refocus regulation on all financial activities that take place in their jurisdiction, making them less vulnerable to the quality of regulation in Iceland or elsewhere, should agree broad principles internationally and should sign common information agreements across all the jurisdictions their banks deal with.

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