The Future of International Financial Centres
Transcript

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Good afternoon everyone. It is a pleasure to be here. My name is Richard Hay. I am a tax lawyer in the City. I have practised here for 25 years. I was an academic for half a dozen years before that, so I have been thinking a lot about offshore centres and the way they interact with onshore financial markets, and it is a pleasure to be here, including with Nicholas. I certainly enjoyed his book, “Treasure Islands”. I recommend it to all of you. As Michael said, I do not agree with a lot of it, although he reports a lot of interesting things, and it is certainly a case to answer for the financial services industry.

So, by way of introduction to my remarks, I am going to sort of cover about five themes here: I am going to talk about why international financial centres exist; I am going to talk a little bit about tax, the question of morality in tax; regulatory standards; globalisation; and conclude with some comments on the future for international financial services.

Just before I give you the benefit of my views, I wonder if I could get a sense of yours. Maybe I will start with, obviously a very complicated proposition, let me reduce it to something rather simple, inappropriately, I know, but globalisation. Good or bad? Those who think globalisation is basically good?

Okay. And those who see globalisation as essentially bad?

Okay. Thank you very much. As far as international financial centres go, or let us say offshore financial centres, should they be shut down, if the world was able to do that? Yes?

Or no…?

Okay, alright, not as much of an uphill struggle as I might have thought!

So, I think Nicholas and I have a lot of common ground. I would like to think we do. If he does not agree with these propositions, I hope he will tell me. But I think we all recognise the importance of prosperous economies to support healthy public finances and private investment, development, poverty alleviation. Even socialists like to have money because they like to give it away. If we do not start off with a productive economy, we have a problem right from the start. And I guess, if we do value prosperous economies, then I think we all accept that business makes a contribution to that. They conduct trade, they contribute to economic growth, certainly they employ people, and if we agree that business has some merit to it – I appreciate that there are issues about trust and regulation but if, broadly speaking, we think business contributes to prosperity, then I think we also need to recognise that business needs infrastructure. Nicholas has referred to roads, schools and hospitals, but I think we need to also recognise that business requires a sound and stable legal system, trained professionals to facilitate business, to do the kind of transactions that Michael was describing, the deals between the pharmaceutical companies in France and the United States, and of course business also requires financial services facilities.

A lot of this takes place, at least in the cross-border context, between international financial centres. They get a bad rap in the press, and, as respects why this happens, they conduct financial services, they facilitate business, they facilitate globalisation – this is a tough gig in the current world. I mean, the public is highly critical of these components, so they are not very well- positioned in terms of attracting a lot of applause from the public, and as respects the offshore dimension of this, of course, it is, by definition, foreign to the country or the press where the criticism arises.

Have you ever noticed this dynamic? You have got a bunch of people in a room, they are looking at a problem, they are thinking about who caused it… Pretty regularly, the person who caused it is one outside the room, right?! So, you know, being foreign is a bit of a disadvantage.

Now, I think there is one thing that I would lay at the door of the IFCs, so small and large: I think they have not done enough to explain to a sceptical public post the financial services crash why their activity is socially or economically constructive, and I think, for this reason, the media of course, who does not print stories like “Shock, finance is well-regulated” – you know, that does not sell newspapers. It is the sort of lurid stories that comment on criminality and the negatives of course that sell newspapers, so we do get a focus on the negative dimension, and I do not think the IF people who staff the IFCs, the ordinary workers there, take too much time off from their day-jobs to explain to us why what they do matters.

What is the essence of financial services’ activity in society? Well, I would say that they conduct capital formation, they collectivise capital, and they transmit it through investment to support trade and economic growth. I mean, if you doubt the importance of financial services in this process, think back to the dark days of
the first quarter of 2008, where we feared global meltdown as a result of the disruption of financial services. It is a very important function in society.

Of course, financial services are strategically important for countries that control them. In the cross-border context, they facilitate the allocation of footloose capital, and what could be more important in a globalising economy or a global economy than directing where capital is deployed? I mean, the United Kingdom is very successful at this. You may be aware that the United Kingdom and its offshore satellites runs 25% of cross-border intermediation in the world. I am not talking just about the UK, but the network of offshore centres that supports it is dominant, globally, in the transmission of capital and the formation of it. The United States is about 12% of cross-border capital. It is a very big market, but much of the United States of course is domestic in nature. Countries compete to control this very important activity. It is a very significant advantage for the United Kingdom that it occupies pole position in the world in this. Of course, I would also make the point that the activity generates good jobs in the information economy. So, it is a very attractive business line. Of course, that is not enough to justify it – I fully accept that, but I think let us just recognise the fact that, as a business activity, there are many who would like to host it if the United Kingdom stumbled and made it available to others.

So why do international financial centres exist? Nicholas has described them as an escape. The perspective that I have, and I have spent 25 years, as I mentioned, as a tax lawyer in the City of London, the world is politically segmented, but economically integrated, and we have tax systems in major countries that are really national fiefdoms. They are ill-suited to facilitating cross-border commercial intercourse. They are really designed to trap revenue within their borders. So, the international financial services lubricate the connections between countries. I am going to review how that happens in a moment, and I think that, without that, as Michael described in his pharmaceutical example, it would be very difficult for a lot of business to take place.

I did notice, in your book, Nicholas, that the overall tone of it is that international financial services are a giant criminal enterprise...! How many people would share that proposition? You know, I do not look at it that way. I am mindful of the fact, as Nicholas would be, there is a billion cross-border financial transactions in a day. I mean, the scale of financial transactions is enormous. And, granted, if you read Nicholas’ book, he’s got a lot of florid prose in it, I would say, that uses words like “murky” etc. and, there is plenty of stories. I mean, let’s face it, when you have got a degree of activity this large in the world, you are going to have criminal activity associated with it. In fact, finance is the lifeblood not only of business activity but criminal activity. So, you are going to expect quite a bit of criminal activity around financial services. It is not that financial services cause it, but they are in business to make money, just like most other businesses, criminals, and they are going to be attracted to the financial system.

Of course, this also poses a question to me. We do want to contain the elements of it that we regard as criminal, so we need regulation. I am going to comment a little bit on this, but the question I am going to throw out from the outset is the importance of cost-benefit analysis in regulating financial services. You know, if you take the view that financial services are a giant criminal enterprise, then anything you can do to slow this beast down is sensible, obviously – you are trying to discourage crime! But if you think financial services has a role to play that is constructive in society, then you need to be a bit cautious about hobbling its ability to perform that central role. I am going to come back to that...

Who uses international financial centres? Well, multinational corporations do of course, hedge funds, private equity, venture capital, insurance, rich people... Ordinary people? How many people think ordinary people do not use international financial centres?

Okay. And how many people think that ordinary people do use offshore services?

Okay. Well, I am going to show you how ordinary people, people with workplace pensions, are heavily reliant on offshore services. In fact, they are probably the biggest user group in the world. When I meet an MP from Glasgow who says “My constituents hate offshore centres - they never use them and they think they are for big companies and the rich,” I say to him, “Do they have workplace pensions?” Of course they do! And is some of this money invested internationally? Do they want diversification in their portfolio? Do they want investment in high-growth economies elsewhere beyond Europe? Of course they do! One of the primary sources of capital in the offshore world are pension funds, or collective funds of any nature.

Just to illustrate how this works, in the Cayman context, we have got, let us say, three investors: we have got pension fund, private investors, other institutional investors – they come from countries with disparate tax characteristics, They want to collectivise their funds. They want to put their money together in one place and then invest it. That is what funds do in the offshore setting. They form capital there and they transmit it through to China or Africa or a G8 country, where the investment is deployed. There will be tax – you see down at the bottom there – in the source country. If you have a big pension fund that is going to invest in a G8 country or in Africa, depending on local rules, they will pay whatever tax is due. They will not pay tax on the neutral platform where they get together, but they will pay tax, again, in the country of residence. I mean, depending on the rules, sometimes pension funds are exempt. Typically, private investors are not. But we end up in this process with two layers of tax and not three, and actually, the fact that Cayman foregoes its potential tax levy is actually quite attractive. What it means, when the money gets back to, for example, the UK or the US, where the ultimate
investor lives, is there is no tax credit for that tax paid offshore. If Cayman levied tax at 10%, only 90% of the money would be left when it came back to the UK. They would either give a tax credit or they would have less money to tax. The fact that Cayman foregoes its tax take there is actually a big benefit, and the suggestion that it is otherwise, that somehow, by foregoing tax, they are part of a criminal enterprise is really slightly, to my way of thinking, a slightly odd way of looking at it.

Now, let us look at this in another context. Let us look at an investment by a group of investors. Let us say we are going to get together and pool capital and invest in China, and we will invest in an infrastructure project in China. Now, they all could go through BDI or Cayman. Why would they do that? Many would assume that is because there is some sort of monkey business involved in the tax domain, somehow this is a drop-off where they avoid tax. The real reason why they do it is because they trust the legal system in Cayman to regulate their affairs. If you have a financier that is going to provide money to this group of investors, and they want to accelerate their loan, imagine their position if they had to go directly to a Chinese company before a Chinese judge. Maybe they are entitled to accelerate their loan, but if they do that, the capital is going to leave the Chinese enterprise and maybe the business would collapse and cause some problems in China. Now, what would you do if you were a Chinese judge? They do not want their affairs regulated under Chinese law, with Chinese professionals and Chinese judges. They want a predictable legal system that they can have recourse to if there is a dispute between them.

If you look at this from the perspective of the United Kingdom, this is a huge benefit, because it means that, even though the United Kingdom is not the imperial power it was at one time, it still has considerable influence in the global economy because its legal system is trusted around the world. People feel comfortable with British legal infrastructure, and do not forget, this generates jobs not only for the finance institutions in the City of London but it is also very important for the financial services community here. It is a way for the United Kingdom to preserve its cultural influence and input into a globalising economy. People come to these centres because they trust their infrastructure.

I mean, as you can see, they are paying, again, here, two layers of tax: they are paying tax where the money is invested, under whatever terms that country chooses to tax; and they are going to pay tax when they get their money home. The suggestion that these international investors are somehow trying to evade tax or engage in criminal activity by meeting in a tax-neutral place where they trust the laws, to my way of thinking, just does not make sense.

This is the principle activity in, for example, British Virgin Islands – 70% of the companies in the British Virgin Islands are incorporated for the Middle East, for investment in China, and for investment in Russia, where, truth be told, people are not that comfortable with the legal systems. The British proposition? Yes, we trust that.

Let us have a quick stop on the question of morality in taxation. I mean, morality has a very important role to play in the tax context. When we design our roles for taxation, morality and the allocation of resources in society is a very important consideration. But when it comes to tax compliance and enforcement, it must be according to law. There is no other way. How can you have everyone expressing a view about whether somebody else should pay tax? It cannot work like that. As Michael noted in his opening remarks, the way it worked with Starbucks just does not make sense. How can you have a company that is exposed to tax if there is a great hue and cry in the press? It cannot work like that. And that is not my idea – this comes from Michael Devereux who runs the Oxford Centre for Business Taxation. This is the leading group of tax academics in the country. At the end of the day, he says, it has to come down to law – that is the only way you can take people’s property away from them.

Nicholas has made the point that countries create incentives to attract international capital, and of course this is what Margaret Hodge has been complaining about in the Public Accounts Committee, that Google, Starbucks, Amazon, somehow manage to spirit their money out of the country through, often, brand payments. That was the big thing with Starbucks of course – it was paying to Ireland and of course Benelux is conventional too. If the United Kingdom does not like that, they can just deny deductibility for royalties in the United Kingdom! Bingo! Fixed! They do not want to do that though, because they do not want to take the economic, and ultimately voter, consequences that go with that decision. So, they prefer to lay out the bait to attract the multinationals in, and then complain that they use it! Where is the sense in that?!! If the politicians do not like the rules or the outcome under them, change the rules!

On the subject of tax competition, the literature is very mixed on this. I note that Nick does not have much regard for the literature. I must say, myself, I often defer to academics on these calls – I am not the most experienced on them, I am not an economist myself. But, broadly speaking, the US is comfortable with tax and regulatory competition. They have operated a laboratory there for 250 years. They have got 50 states that compete with each other. They have had plenty of experience, a couple of centuries of experience, to evaluate what the implications of that are, and the Americans are comfortable with competition.

In the EU, they are not. It is a series of national fiefdoms. Look at how hard it is for them to cooperate in a common construct in the EU – it is just alien to the way they proceed in the UK. And you often get this narrative in the press, that tax competition is ruining public finances, or that payments to offshore centres or crafty tax
professionals or multinational corporations, that the public finances in Europe are going to hell in a hand-basket because you have got so many people who are undermining the system. Well, here is the reality: in the EU, they take, through tax, nearly 50% of GDP. Governments do not produce that. That is what they take away from individuals and businesses in tax and spend. They get 50%! How serious is this problem with a race to the bottom? How much more do they need?! In France, they have 55%, Finland takes 57%! What do they need, like 80%? Should they not leave a little bit in the pot so that business can invest and produce the economic goods going forward?

Singapore and Hong Kong, their Governments take 22% of GDP. They are pretty successful economies. Now, if you were in a region that was taking 50%, how would that affect your competitiveness? I mean, it is going to be difficult, right? Your company is set-up there. They are going to be paying much higher taxes. You are going to have difficulty attracting capital. That would be certainly my perception, and I think as well, you would not be too keen on competition because you often find yourself on the back end of it.

By the way, this is a great book, if anybody is interested in this subject, this book, edited by Andrew Morris, available on Amazon – not quite the big seller that Nick’s book was, top 10 on Amazon by the way when it came out. But this book looks at offshore financial centres and regulatory competition – it is written from an American perspective, and you will see they take a much different view, quite a benign view on tax competition.

The one I was just showing you here, this is a Chatham House publication from last year. You can guess the broad nature of the content from it. But I just note this, that even in the UK, I think you are a Fellow at Chatham House, Nick, so no doubt a colleague, a former colleague of yours...

Just one more commentary on Europe... This first comment here I attribute to Angela Merkel. She has pointed out that Europe has 7% of the world’s population, 25% of its GDP, and pays 50% of its social welfare spending. I mean, this is a problem. This is a problem with public finances! And, often, we like to think that we can continue this comfortable environment - I mean, why not? No one wants to take the punch-bowl away and stop the party. Certainly, politicians do not want to do it on their own watch. They want to leave it to the next lot to have to do it. But the conclusion that I draw from this is that enhanced tax collection and reform are not enough to achieve sustainable finances. We need some structural changes in government expenditure in Europe. Sorry about that, but at the moment, we are on borrowed time – we can all feel that.

On the subject of regulation, I made the point earlier that countries compete to host financial services. A very important point to bear in mind is that, if you are a dominant country, setting the rules, you can use regulation to harass competitors, and a lot of what we see going on that passes for regulation of financial services is really countries who are successful, or maybe see their positions slipping, want to entrench their position by adopting regulation that flatters their own commercial interests. So, just bear in mind this is not quite the arid, antiseptic process that you might think it is. I am not saying that there is not a lot of merit in it, but, you know, it is part of the competitive process.

Nick’s commented on secrecy. I think he notes that this happens with centres large and small. There is a lot of debate at the moment about whether we should have public registers for companies and trusts. Our Prime Minister is committed to that in the United Kingdom. I must say, I have serious reservations about that, and it is one thing Nick and I might discuss a little bit.

But you may know that, in the British offshore centres, they collect beneficial ownership information on companies and trusts, and they have done so for a decade. They hold that information in private hands and they make it available to Government when they ask for it. The suggestion that they are secretive...? Well, they are much less so, I would say - and I do not know that Nick would disagree with this but he will get a chance to give us his view – that they are much more transparent, and information is much more readily available there on beneficial ownership than it is in the United Kingdom or the United States.

I am going to illustrate this, and I include within this Benelux, the Netherlands in particular... Switzerland is very good at that. They have collected beneficial ownership for some time. Of the G8 countries, France has ambitions to do it, the United Kingdom... None of them are anywhere near as advanced on this, which is really the core of secrecy, as the British offshore centres.

You get the impression from reading the press that the big countries are all well-organised on this and they just need to bring the smaller ones up to their standard – we need a level playing field. I say: bring it on! The smaller centres occupy a leading position on this. In our practice, we produced this book on the left, “Towards a Level Playing Field”, in 2003, and the purpose of this book was to show to the OECD, five years after they had launched their initiative, their attack on small financial centres, that actually, standards in the small financial centres for transparency were higher than they were in OECD countries. OECD took a bit of a black-eye on this. It took them a few years to get organised to do their own research, but as you see, in 2006, they had realised, by this time, that the blockage in achieving success in their process was not the cooperation of the small financial centres but the cooperation of their own members, the big countries who could self-exempt from the standard if they wanted to export to others.
Where are we now? Well, Michael referred to this project. It was conducted by three academics, and probably the best-known of the three is an Australian by the name of Jason Sharman. They had a really cool project. What they did was they sent out email solicitations to 7,500 corporate service providers in 182 countries around the world. They said we would like to incorporate a shell company who want to avoid excessive tax and they put suggestions in there that maybe there might be terrorist activity etc. just the sort of things that would have put your antennae up if you were a service provider. You could see some mischief coming on this. Then what they did was they checked to see who offered to establish the company, without asking for the ownership information that is required under international standards. So it was just a purely empirical exercise, no load – it is not that they are going into the United States and they are being nice there because the United States pays the fees of the agency conducting the evaluation, which often skews outcomes. They just sent out these blind emails and waited to see what came back. And guess what happened…?

This is the list, from top to bottom, of compliance with international standards. The ones at the tippy-top are the British offshore centres. Around the middle, the United Kingdom, and actually, this is a little mis-place, it is a little too high on the graph, this is the US line, right here. The bottom of compliance globally was in the United States. Why? They have the capacity to self-exempt! So, I just point this out, ten years after, we challenged the OECD and said get your own countries in line – if this is really important, if secrecy is destroying the global economy, you should be able to get the countries who run your project in line! The United States funds 23% of the OECD budget, and when I kept needling the head of the project, he said to me, eventually, “What do you expect me to do about the United States?” I said to him, “You need to get the United States on-board!” What he meant was: if I criticise them, the lights will go out in my office!

So, globalisation. What is its impact on developing countries and what is the role that financial services plays in this?

Well, China has been the biggest poverty reduction machine in history. Over the last two or three decades, they have had 500 million people come out of poverty. Now, there are many reasons for that – agricultural reform is one, probably the dominant one, but does anybody think that China would have emancipated as quickly without the local presence of Hong Kong and Singapore?

What is interesting about this is, when Hong Kong reverted to China, the United Kingdom lectured China about the importance of keeping Hong Kong’s special status as a regional financial centre. They regarded that as critically important to development in the region.

Fast-forward twelve years later to the G20, hosted by the UK in 2009, and the UK and France were planning to shut down the offshore world. Does anybody remember what country derailed the United Kingdom on that? China. China was the one who said, “No, you cannot interfere with these offshore centres!” They put it on the basis of the importance of not coming after Hong Kong and Macau, but had a chance to speak to some senior Chinese policymakers afterwards and they said, “These centres are important to us! We are on top now, and we are capital exporters. We want these places so we can intermediate our funds out and buy commodities and whatnot that we need in order to grow.” So, the Chinese certainly recognise the value of this, and it has contributed, I think, materially, to poverty reduction there.

International finance is obviously required for investment and development.

This third bullet-point, does it curtail crony allegation of capital? One of the key problems you have with corruption in countries is that capital is restricted to those closely connected with the elite. So, what happens in China? You have got an entrepreneur in the hinterland, not connected with the elite, he needs capital for his business – he cannot get it because he is not connected with the leadership. What he does is he goes to Hong Kong. He has got a relative in Hong Kong. He gets the money he needs from Hong Kong, starts his business, somewhere in the middle of China? You are the Chinese upset about that? Not a bit of it! They had their money to give to cronies and they got active business enterprise financed by somewhere outside.

Contrast the same entrepreneur in Africa – where does he go? Maybe Mauritius…? Just a little suggestion here that it may be that Africa suffers from a dearth of proximate finance centres, that their economic development is held back by that.

The future for international financial centres. One of my key points is that upgraded regulation should take cost-benefit analysis into account. One of the taunts we get from NGOs is: if you believe in transparency etc. how come you will not incur unlimited costs to get it? Answer: because we think that one needs to think about cost-benefit in this – is this worth taking on, is it important to do this? And in fact, the Financial Action Task Force, the global anti-money-laundering chiefdoms in the world, these guys have never, ever, since 1989 when they were founded, done cost-benefit analysis on their work. Why? They know what the outcome would be. They have seen the academic studies that have done it, that have suggested that this regulation has been far more costly than the benefits it’s created.

Foreign Account Tax Compliance Act or FATCA, you are probably familiar with that – I will not go into the details there, but that is throwing private money on the bonfire to collect the ashes.
International financial centres support globalisation. It kind of depends what you think about that. If you do not like globalisation, you probably do not like IFCs.

Importantly, of course, countries do not have friends, they have interests, and my principal reason for optimism about international financial centres is that G20 countries, in particular, will protect these centres for cross-border finance in their own interests. So, the European perspective on this may be a little influenced by the way the French look at it. We can see this works in practice, but does it work in theory…?

Thank you.