Global Financial Strategy
REGULATION MATTERS

IFCs play key role in boosting growth in developing countries

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In an extract from his latest research paper, Professor Jason Sharman of the Centre for Governance and Public Policy at Griffith University in Australia explodes the myth that international financial centres are the primary problem in attracting and hosting illicit funds from the developing world

International Financial Centres can increase foreign and domestic investment in developing countries which helps to alleviate poverty.

An example of this can be seen by the most successful poverty reduction effort in history – that of China. Since 1978, millions have been lifted out of poverty, with openness to foreign direct investment regarded as a key driver for Chinese growth during this period. FDI is between three and ten times more effective than foreign aid in boosting growth, with the World Bank declaring that "foreign direct investment remains one of the most important tools in the fight against poverty".

However, there have been suggestions in the past that IFCs have a negative impact upon developing countries. Largely, these themes centre around IFCs having no benefit to developing countries, and at worst actually impoverishing already poor countries.

The first of these negative views argues that IFCs are havens for illicit wealth plundered from developing countries. The view that IFCs are the primary problem in attracting and hosting illicit funds from the developing world is deeply misleading. Large powerful G20/OECD states are the main problem in facilitating corruption and other crimes in the developing world. In fact, the World Bank and the International Monetary Fund have identified corruption as the single biggest obstacle to economic development. Furthermore, the World Bank has found that US corporate vehicles are the most likely to be used in laundering the proceeds of corruption from the developing world.

Unsurprisingly, these same powerful states have a strong incentive to overlook this evidence and shift the blame to small, weaker players outside the most important international clubs.

Criticisms regarding issues such as round-tripping and tax avoidance have also arisen, though these are often without credit. The simple stolen assets haven and round-tripping argument of Chinese linkages with IFCs are both incompatible with available evidence.

Where existing treatments have not simply dismissed IFC-mediated capital flows out of hand as a statistical quirk or anomaly (and many have), the movement of capital between China and various IFCs has been explained by the notion of round-tripping. The 'foreign' investment in question is said to be domestic Chinese money that is sent out of the country and returned via one or more IFCs. Specifically, a Chinese firm would incorporate an International Business Company (IBC) in an IFC, pass the funds through the IBC back to

China, by which point the funds had been transmuted from domestic to foreign investment, taking on the citizenship of the jurisdiction in which the IBC had been incorporated.

But the round-tripping account cannot explain why if IFC-mediated flows to China are driven by tax differentials only, these flows have increased as the tax differentials in question have narrowed and then disappeared. Much of the money attributed to round-tripping is genuinely foreign. Of the money that is round-tripped, the motivation is much more the value-adding pursuit of efficient institutions than tax differentials.

Flows of foreign investment into China and increasingly, outbound flows of investment from China have been predominantly routed through tax-neutral IFCs. While Hong Kong has predictably been important, the British Virgin Islands has consistently been the second-largest foreign investor in China, while ten times more Chinese out-bound investment goes to the Cayman Islands-domiciled structures than to the US.

China's relative openness to IFCs has been a significant contributory factor driving Chinese growth and poverty reduction over the last three decades.
But why is this? The argument is that by routing investment through IFCs, foreign and domestic investors can utilise institutions that lower transaction costs, in turn resulting in larger capital flows and more efficient use of this capital. Transaction costs refer to the costs of fully specifying and enforcing economic exchanges.

The primary beneficiaries of lower transaction costs in China have been small and medium-sized enterprises, which have faced severe obstacles in obtaining credit from banks and being listed on local stock markets. Ensuring the adequate flow of capital to such enterprises is crucial because they make a disproportionate contribution to poverty alleviation.

Regulations and laws in developing countries are commonly confusing, rigid, obsolescent, politicised and poorly enforced. IFCs therefore offer a natural complementarity for developing countries arising from an institutional environment characterised by sophisticated and impartially-enforced regulations and laws that are specifically tailored for foreigners.

Chinese firms, as well as foreign investors, form links with IFCs to capitalise on the efficient, transacting-cost reducing institutions IFCs host. In this sense, investors benefitting from IFCs are of three types: ethnic Chinese living outside the People's Republic of China such as Hong Kong and Taiwan, those within the PRC and foreign investors.

The argument concerning the importance of IFCs for Chinese development and poverty alleviation may shed new light on the G20, particularly the meeting in London 2 April 2009. The biggest controversy erupted between the French and Chinese delegations, with the point of contention being IFCs or "tax havens". Specifically, French President Sarkozy, and to a lesser extent Germany's Chancellor Merkel, wanted the G20 to endorse the OECD's listing of tax havens, released that same day after a phone request from former UK Prime Minister Gordon Brown, or perhaps even to release this list as part of the summit's communique. Furthermore, the French government wanted a direct threat of sanctions for those on the list. These sanctions ranged from relatively minor administrative measures, to blocking loans to listed jurisdictions from the World Bank, IMF and other multilateral development institutions.

China disagreed on all counts, and this division threatened to de-rail the negotiations. The compromise brokered by President Obama was to 'note' the OECD's list, to exclude Hong Kong and Macau, and to defer any specific talk of sanctions. To what extent can the Chinese opposition to action against IFCs be seen as being motivated by recognition that these centres play a beneficial role in developing the Chinese economy? Given the highly

personalised and immediate nature of summit diplomacy it is impossible to come to definitive conclusions, but there is supporting evidence for this proposition.

There is some reason to think that the Sino-French difference over IFCs was a self-interested realisation of the positive contribution made by such centres to the Chinese economy and the consequent alleviation of formerly widespread poverty.

The consistent support that the Chinese government has extended to Hong Kong's finance centre strengthens the impression that it is aware of the benefits international financial services provide for the Chinese economy generally. Despite pre-1997 fears that Beijing might engage in de-stabilising interference in either the finance industry directly, or its broader institutional underpinnings, nothing of the sort has been observed. Current efforts to develop Shanghai as a financial centre provides testimony of the benefits the Chinese government expects to reap from IFCs in the future, at home and abroad.

The tax-neutral environment provided by IFCs is a necessary but not sufficient condition for the role they play. More important are the sophisticated, robust and efficient institutions they host.

IFCs by definition allow outsiders to easily access and profit from these efficiency promoting institutions. Rather than funds being hoarded offshore, they are then re-invested to produce growth. To the degree that developing countries shut themselves off from IFCs, they will tend to prevent both foreign and domestic investors being able to use IFC institutions to benefit the local economy. In the longer term China, India and other developing countries may create the panoply of specialised, complex institutions presently found in IFCs. In the meantime, however, the evidence presented suggests that there is much to be gained by developing countries cultivating closer relations with IFCs to foster growth and reduce poverty.

Explanations of the large IFC-mediated flows into and out of China and India premised on a simple tax-arbitrage logic cannot account for the fact that the tax incentives have largely been withdrawn, but these flows have continued to grow. Because existing explanations fail, it is necessary to look further.

No doubt there are many factors that explain why China since 1978 (and India since 1991) has managed to lift hundreds of millions of people out of poverty. But a key factor that has previously been ignored is the relative openness of developing economies to IFC-mediated flows of capital from both domestic and foreign investors.

This is an extract from International Financial Centres and Developing Countries: Providing Institutions for Growth and Poverty Alleviation.

Commentators have urged the European Union to endorse the IFRS9 accounting standard currently being finalised by the FASB and the IASB.