



INTERNATIONAL FINANCIAL CENTRES AND DEVELOPING COUNTRIES:

Providing institutions for growth and poverty alleviation

ABSTRACT

This paper tests whether and how International Financial Centres (IFCs) provide support for economic growth and poverty alleviation among developing countries. It is argued that investment structures and financial intermediation available in IFCs can provide important support for economic growth in developing countries, with evidence drawn from the Chinese and Indian experiences. IFCs contribute by helping domestic and foreign investors in developing countries access the kind of efficient institutions necessary to drive growth, but which are often unavailable locally.



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Professor Jason Sharman

COMMONWEALTH SECRETARIAT

The commonwealth is a voluntary association of 54 member states. The members share a set of common values and span the globe geographically with members in six continents. The membership is economically and culturally diverse with sizes ranging from the largest to the smallest in the world. Despite this diversity the organisation works by consensus with each member holding equal status in the association. The commonwealth secretariat was created in 1965 as an intergovernmental organisation to provide the commonwealth's bureaucratic capacity. It exists to implement the decisions of commonwealth heads of government and operates by providing technical assistance, capacity-building and advice, and policy development services to members. The secretariat also helps the membership through supporting coalition-building amongst commonwealth members, information sharing and analysis. The secretariat also works together with other international organisations, like the UN, to deliver its mandates from commonwealth governments.

The secretariat has 12 divisions and units with the responsibility of delivering the secretariat's work programme in diverse policy areas including institution building, economic policy advice political and legal affairs. The economic affairs division deals with a range of policy areas including trade, environment and issues of particular interest to small states – which constitute the majority of the commonwealth's membership. In addition, the division works on a number of global issues including supporting the implementation of anti money laundering/countering terrorist financing rules, promoting commonwealth perspectives in discussion of the Paris declaration on aid effectiveness and reform of international institutions. Commonwealth countries represent diverse interests in the debate on the role of international financial centres in the global economy. Over the past decade, the secretariat has supported the development of a consensual approach to this issue and continues to work towards this end.

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CONTENTS

EXECUTIVE SUMMARY	4
PLUNDERED WEALTH AND CORPORATE SECRECY	10
ROUND-TRIPPING AND TAX ARBITRAGE	13
EXPLAINING THE CHINA-IFC RELATIONSHIP: TRANSACTION COSTS AND EFFICIENT INSTITUTIONS	17
INDIA IN COMPARISON	28
APRIL 2009 LONDON G20 SUMMIT	33
CONCLUSIONS	35
BIBLIOGRAPHY	37

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EXECUTIVE SUMMARY

This paper tests whether and how International Financial Centres (IFCs) provide support for economic growth and poverty alleviation among developing countries. It is argued that investment structures and financial intermediation available in IFCs can provide important support for economic growth in developing countries, with evidence drawn from the Chinese and Indian experiences. IFCs contribute by helping domestic and foreign investors in developing countries access the kind of efficient institutions necessary to drive growth, but which are often unavailable locally.

Governance and institutions are now regarded as the key determinants of economic growth, and related poverty reduction. Efficient institutions promote growth by lowering transaction costs and thereby facilitating exchange. Transaction costs refer to the costs of fully specifying and enforcing economic exchanges. Because regulations and laws in developing countries are commonly confusing, rigid, obsolescent, politicised and poorly enforced, firms may seek efficient institutions abroad.

IFCs offer a natural complementarity for developing countries arising from an institutional environment characterised by simple, flexible, modern, sophisticated and impartially-enforced regulations and laws that are specifically tailored for foreigners. Small- and medium-sized enterprises from developing countries, the engines of job and income growth, may be able to access capital much more efficiently in or through IFCs than domestically. For foreign investors, IFCs ease the path of entry into developing countries. An explanation premised on the search for efficient institutions in IFCs sheds light on why, for example, Mauritius is the biggest foreign investor in India, or why the Cayman Islands attracts ten times more capital from China than does the United States.

Funds invested in IFCs are seldom final destinations for capital from the developing world, but rather are commonly brought back to be put to work in the country of origin. Such flows allow investors and private individuals to reconcile their desire for asset protection with the imperative to contribute to national development.

An account giving due weight to the role of the transaction-cost-reducing institutions in IFCs is a better fit with the evidence than the two most common rival explanations of the developing country-IFC relationship. The first of these negative views argues that IFCs are havens for illicit wealth plundered from developing countries. In fact, however, a wide variety of sources demonstrate that kleptocratic leaders find a warm welcome for their ill-gotten gains in OECD centres, which often provide a higher level of corporate secrecy (in particular) than that available in IFCs. Another version holds that capital flows between IFCs and developing countries represent crude tax arbitrage in the form of 'round-tripping': domestic money is exported and then re-imported via IFCs to qualify for tax breaks available to foreign investment. Yet for both China and India, the tax arbitrage account fails to explain why as tax breaks have been withdrawn, the IFC-mediated flows have only increased.

A positive role played by IFCs in enhancing economic growth and poverty alleviation in developing countries may also help to explain the Chinese government's supportive attitude towards IFCs. This attitude is most notable with regards to Hong Kong, from the hand-over negotiations in the early 1980s, to the London G20 summit in 2009.

International Financial Centres and Developing Countries: Providing Institutions for Growth and Poverty Alleviation

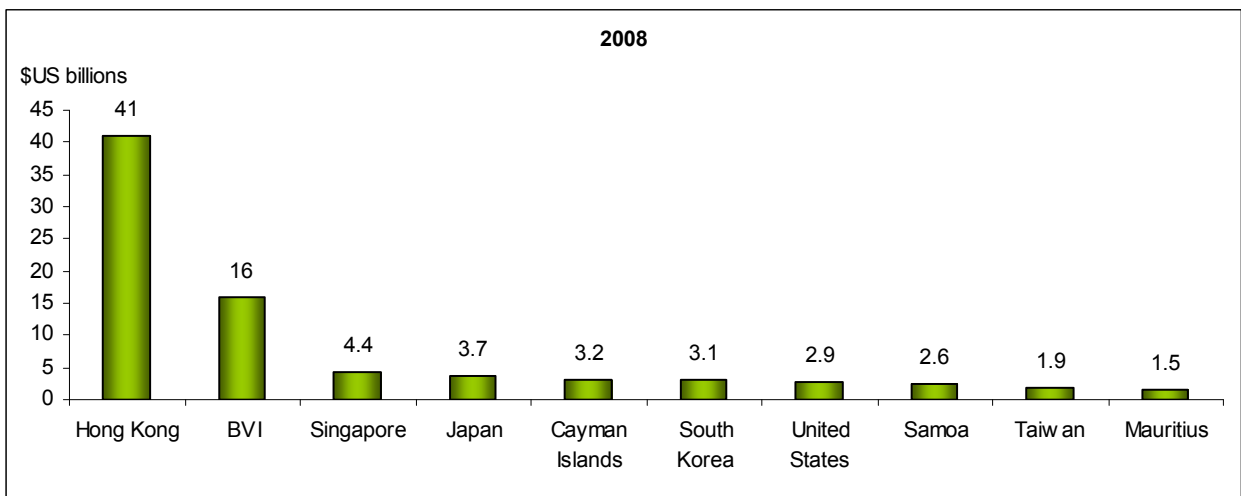
This paper tests whether and how International Financial Centres (IFCs) provide benefits for developing countries in fostering economic growth and poverty alleviation. The primary focus of the project is on China and its relations with IFCs. A supplementary concern is drawing out comparisons with India and its connections with IFCs. More generally, the project seeks to explore the possibility that IFCs may be an under-valued asset for assisting poorer countries to meet their development goals.

Recent scholarship in economics has emphasised the positive role IFCs can play for third countries. They are associated with increased foreign and domestic investment in nearby third countries, as well as boosting the competitiveness of these countries' banking sectors (Hines 2009; Rose and Spiegel 2007). IFCs themselves are characterised by highly positive governance environments in terms of the transparency, impartiality and durability of their institutions (Dharmapala and Hines 2009). But most scholarship has dealt with the relationship between IFCs and developed, rather than developing, countries. In remedying this gap, it is argued here that IFCs may provide important flow-on benefits for developing countries, with evidence drawn from the Chinese experience, and to a lesser extent that of India.

Why is China the starting point for this project? By far the most successful poverty reduction effort in human history has occurred in China from 1978, during which time hundreds of millions have been lifted out of poverty (Ravallion 2009). Openness to foreign investment is widely regarded as a key driver of Chinese growth during this period. In turn, the World Bank has declared that 'foreign direct investment (FDI) remains one of the most important tools in the fight against poverty' (Klein, Aaron and Hadjimichael 2001: 1). Headly (2007), calculates that the FDI is between three and ten times more effective than foreign aid in boosting growth. Moyo (2009) draws similar conclusions. Less widely appreciated, however, is that flows of foreign investment into China, and increasingly outbound flows of investment from

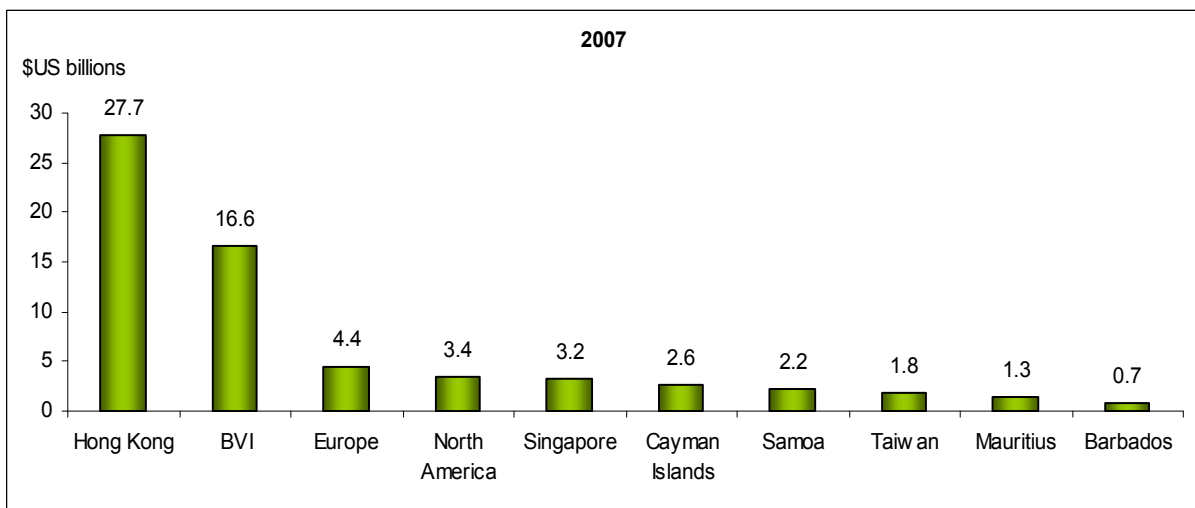
China, have been predominantly routed through tax-neutral IFCs. While Hong Kong has predictably been important, the British Virgin Islands has consistently been the second-largest foreign investor in China (see Tables 1 and 2), while ten times more Chinese out-bound investment goes to the Cayman Islands-domiciled structures than to the United States (See Table 6).

Table 1: Top ten FDI sources to China 2008



Source: US-China Business Council, *Foreign Investment in China (2009)*

Table 2: Top ten FDI sources to China 2007



Source: National Bureau of Statistics of China, *China Statistical Yearbook, Beijing, China; Statistics Press*

With these facts in mind, the argument put forward is that China's relative openness to IFCs has been a significant contributory factor driving Chinese growth and poverty reduction over the last three decades. Drawing briefly on India's analogous experience, the implication is that other developing countries may also benefit from a greater openness to IFCs and the flows of investment they mediate. How can IFCs help poor countries to meet their development goals, most especially alleviating poverty? 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. The primary beneficiaries of these 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 smaller enterprises are crucial, because they make a disproportionate contribution to poverty alleviation.

Furthermore, because institutional and governance deficits have been identified by the World Bank as the single greatest obstacle to economic development, to the extent that other developing countries can draw upon the IFCs' institutions in ameliorating domestic shortcomings, IFC-mediated capital flows may provide a significant fillip to growth. To test this notion, the project will analyse why capital has taken the indirect route into and out of China via IFCs, and what the implications have been for the Chinese economy. India is a supplementary case for comparison, briefly demonstrating how the relationship with Mauritius may play a somewhat analogous role in fostering growth.

The final concern of this paper is to hypothesise whether the Chinese government's opposition to a crack-down on IFCs reflects a belief that these centres are in fact beneficial to the Chinese economy. At the April 2009 G20 summit China blocked efforts to endorse the OECD's three-tiered tax listing (which instead was merely 'noted'), and China has been generally accommodating towards both sovereign and non-sovereign IFCs. Contrary to the fears expressed before 1997, China has consistently defended the finance industry in Hong

Kong, as well as seeking to build up the financial centre in Shanghai. These actions in defence of IFCs tend to support the proposition that these centres are perceived to exercise a positive influence on China's economy.

Before laying out the logic of this argument and the evidence to support it, however, it is first necessary to consider earlier writings on this topic. Where the relationship between developing countries and IFCs has received any attention at all, two themes have dominated. Both are negative, arguing that IFCs at best have no benefit to developing countries, and at worst actually impoverish already poor countries. The first, discussed immediately below, is that IFCs are important for developing countries only in functioning as havens for illicit wealth plundered from these economies, and as providers of corporate secrecy to facilitate financial crime. The second is discussed under the section on 'round-tripping'. Given this conventional wisdom, the first task of the paper is to examine the shortcomings of these two accounts that suggest the need for a more rounded and nuanced appreciation of the relationship between IFCs and the developing world. Because these two negative accounts fail to match available evidence, this strengthens the argument concerning the benefits IFCs may provide in fostering development and reducing poverty.

PLUNDERED WEALTH AND CORPORATE SECRECY

The usual picture of relations between IFCs and non-IFC developing countries (remembering that most IFCs themselves are developing countries) is often painted in dark colours. The argument that IFCs can and do provide significant benefits to developing countries is thus very innovative, perhaps even heretical. The long report from the Norwegian government, *Tax Havens and Development* (2009), concedes in principle that tax havens may provide some benefits to developed countries (2009: 71-72), but seems to regard it as entirely unimaginable that these jurisdictions could help developing countries also.

Although the majority of this paper is devoted to examining the positive contribution that IFCs can make to the developing world, it would be remiss to ignore the work that has been done in this topic before (see for example Oxfam 2000; Norway 2009). Though there is not space to provide a detailed response, it is worth pointing out a number of misconceptions in this literature, but also some interesting points of convergence between NGOs, like the Tax Justice Network, and those in IFCs. IFCs are variously said to be the predominant venue for hiding stolen wealth, generally through private banking facilities, and to encourage a variety of crimes like tax evasion and embezzlement in developing countries by offering a higher level of corporate secrecy than is available in OECD centres. These charges do not stand up to closer scrutiny.

Popular stereotypes and the self-interested rhetoric of powerful countries to the contrary, available evidence indicates that the G20/OECD countries are far more likely to host the proceeds of grand corruption than small state IFCs. No doubt, as with any other illicit activity, the difficulty of obtaining conclusive evidence means that conclusions can only be provisional.

Perhaps the most compelling source for this conclusion is a report, *Undue Diligence*, released by the NGO Global Witness in 2009.

As a recent report by the Tax Justice Network points out, however, bank accounts and real estate may be a secondary issue compared to the problem of corporate secrecy in facilitating financial crime in the developing world and more generally: 'For decades it has been believed that bank secrecy... is the touchstone of offshore financial secrecy. This is a myth... Trusts, for example, or certain kinds of anonymous companies offered by places like Delaware in the United States, are used to disguise true identities and ownerships in far more devious and effective ways' (Tax Justice Network 2009: 2). The report concludes 'The major global players in the supply of financial secrecy are mostly not tiny, isolated islands, but rich nations operating their own specialized jurisdictions of secrecy'.

A recent statement by Senator Carl Levin strongly confirms the notion that corporate secrecy is at least as much a problem created by G20/OECD countries, and particularly the United States, rather than small state IFCs. Thus Levin noted:

Our 50 states are forming nearly 2 million companies each year and, in virtually all cases, doing so without obtaining the names of the people who will control or benefit from those companies... Most of our States allow hidden owners to buy companies online within 24 hours of a request. In two States, for an extra \$1,000, hidden owners can form a U.S. company within a single hour (Levin statement, 5 November 2009).

By way of comparison, the number of International Business Companies formed in all the world's IFCs is something like 250,000 per annum (*Offshore Investment* 2009). To make matters worse, as a general rule, direct evidence suggests that in addition to forming a large majority of the world's international companies and trusts, onshore jurisdictions like the US and UK are far less likely to establish the real owner of such corporate vehicles than IFCs (Sharman 2010). A number of US government reports confirm this conclusion (GAO 2006, FinCEN 2006). World Bank research has suggested that US corporate vehicles are the most likely to be used in laundering the proceeds of corruption from the developing world (World Bank 2010,

forthcoming).

Thus, as is the case with banking, when it comes to corporate secrecy, the conventional picture whereby IFCs are seen as 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, remembering that the World Bank and the IMF have identified corruption as the single biggest obstacle to economic development and the associated social and humanitarian benefits (World Bank/IMF 2006). Unsurprisingly, these same powerful states (and the international organisations they fund and dominate) have a strong incentive to overlook the evidence of their culpability and shift the blame to small, weaker players outside the most important international clubs.

ROUND-TRIPPING AND TAX ARBITRAGE

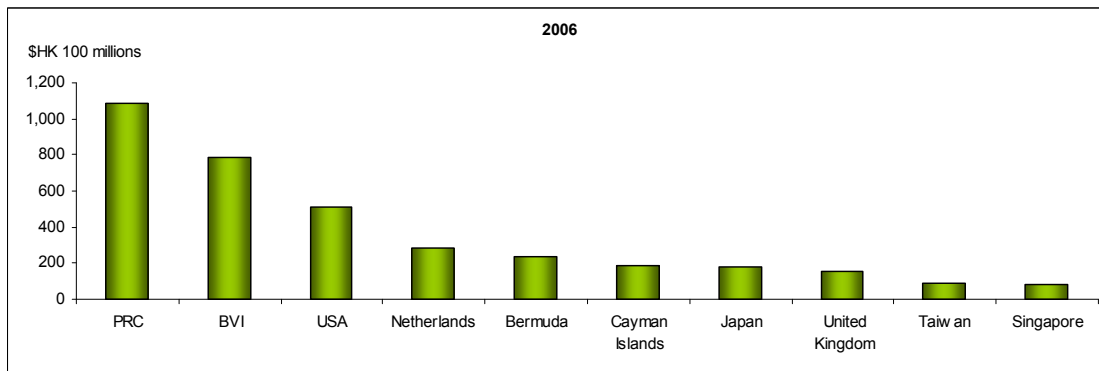
This paper began with some rather startling facts about the sources and nature of foreign investment into and out of China, to repeat, the world's greatest poverty-reduction machine over the last three decades. In 2006 the Cayman Islands attracted 44 per cent of China's out-bound FDI. Indeed, Cayman-domiciled structures attract ten times more of this kind of investment than does the United States. Looking at the other side of the equation, the ten biggest sources of FDI moving into China include the British Virgin Islands (second), the Cayman Islands (fifth), Samoa (eighth) and Mauritius (tenth) (see Table 2, page 8). This section argues that trying to explain these flows as crude tax arbitrage that adds no value does not fit with available evidence.

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 (there are strong methodological reasons for thinking that tax minimisation plays much less of a role in capital flows to and from developing countries in general than many would suggest, see Fuerst and Riedel 2009). Much of the money attributed to round-tripping is genuinely foreign, as explained in the following section. Of the money that is round-tripped, the motivation is much more the value-adding pursuit of efficient institutions than tax differentials.

There are good reasons to think that FDI figures actually understate the China-IFC investment linkage. Firstly, because while the standard definition of FDI is an interest of 10 per cent or more in a foreign firm, the Chinese statistical office adopts a higher threshold of 25 per cent. Secondly, because it seems that funds moving from China to the Caribbean often go via Hong Kong. This is evidenced by the fact that Caribbean IFCs like the British Virgin Islands are also very prominent in FDI to and from Hong Kong (see Tables 3 and 4). For example, in 2005 the British Virgin Islands were the source of 31 per cent of FDI into Hong Kong and the destination for 44 per cent of out-bound FDI from Hong Kong. FDI in China is particularly

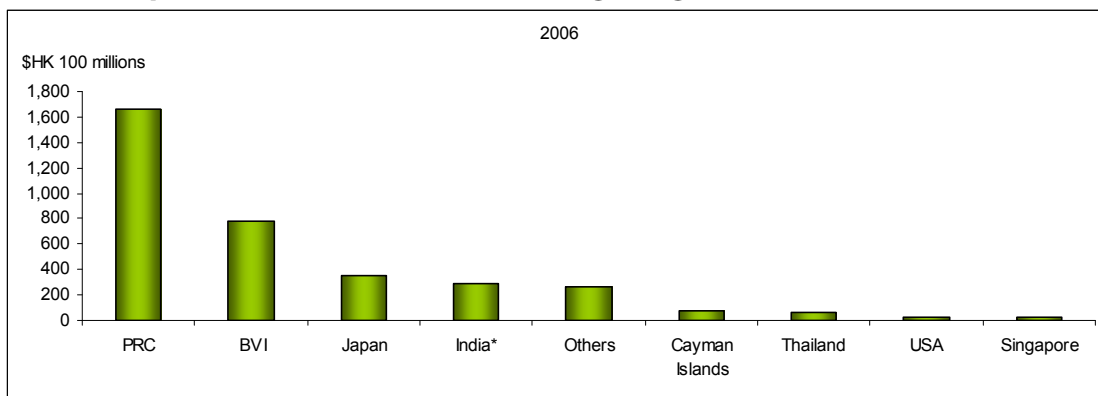
significant because it is the largest recipient of such flows in the developing world. To the extent that FDI has been important for growth and poverty reduction, there may be important lessons for other developing countries also.

Table 3: Top ten FDI sources to Hong Kong



Source: National Bureau of Statistics of China, China Statistical Yearbook (2008).

Table 4: Top ten FDI destinations from Hong Kong



Source: National Bureau of Statistics of China, China Statistical Yearbook (2008).

Both intuitively and in terms of the prevailing logic of foreign investment flows, the huge sums of capital to and from China coming from IFCs is surprising. Small IFCs are unlikely FDI destinations for a number of reasons. IFCs are small jurisdictions with small markets, and tend to have very few natural resources, ruling out two common rationales for foreign investment. Despite some wage inflation in recent years, China has all the labour it needs, particularly in the inland provinces, and thus there is unlikely to be a push to combine Chinese capital with

foreign labour. In any case, the small populations of IFCs again means that this is an unlikely explanation for why they have attracted so much investment. If anything the prominence of the British Virgin Islands (population 22,000) as a source for in-bound investment to China is even more mystifying.

Where existing treatments have not simply dismissed these 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. It should be noted that discussion of round-tripping has not been limited to China, with Indonesia cancelling its tax treaty with Mauritius in 2005 on the grounds that Indonesians had been round-tripping funds via Mauritius. The issue of round-tripping through Mauritius is further discussed in the section on India.

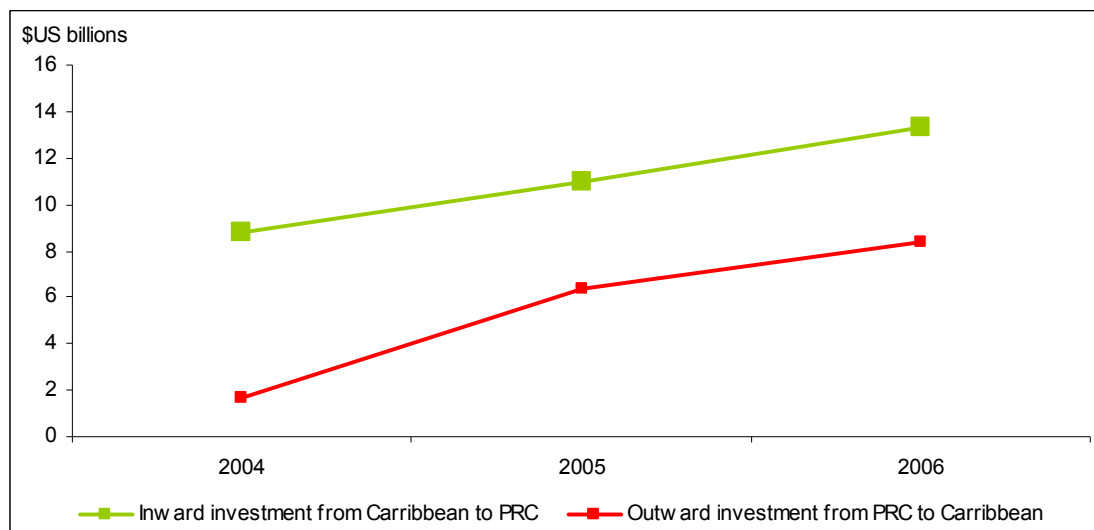
The logic behind this ruse is said to be the desire of Chinese investors to capitalise on special incentives offered to foreign investors but not available to those from inside the country (Xiao 2004). One of the special incentives was superior protection of property rights for firms created or controlled by foreign capital (Patibandla 2007). Another related motivation is said to be Chinese firms returning profits abroad as FDI rather than simply as foreign profits to escape tax obligations (Vlcek 2009; Prasad and Wei 2005). Finally, as with any large cross-border flow of money, there is probably some portion of illicit funds.

Yet there are serious problems with the round-tripping account that ignores both the foreign component of these flows, and the institutional logic behind investors' decisions (discussed below). The property rights rationale was diminished after 2004 once the PRC Constitution afforded greater protection to domestically-owned property (Tsai 2006), yet the flows to IFCs continued to increase after this date. Similarly the tax rationale for round-tripping was

reduced after the passage of the Enterprise Income Tax Law in March 2007 (Vlcek 2008: 2), though local governments continue to offer some tax incentives for foreign firms. On the evidence so far, the end of the tax advantage has not reduced Chinese investment to and from IFCs. Thus as the factors that were said to underpin the round-tripping disappear, and flows to and from IFCs continue or even increase, simple round-tripping becomes less plausible. Other alternative explanations must be considered.

Another anomaly for the round-tripping account is that if it were simply a matter of the same money exiting and re-entering China, the flows in each direction should be at least roughly the same. In fact, however, as Sutherland and Matthews (2009) show, there is significantly more money entering China from IFCs than is exported from China to these centres. In the period 2004-2006 capital outflow to the Caymans and the British Virgin Islands was \$16.4 billion, whereas capital inflow from these centres over the same period was \$33 billion (2009: 18; see Table 5).

Table 5: Flows between Cayman Islands/BVI and China (billion US dollars)



Source: SSB (2007, 2005).

EXPLAINING THE CHINA-IFC RELATIONSHIP: TRANSACTION COSTS AND EFFICIENT INSTITUTIONS

The simple stolen assets haven and round-tripping argument of Chinese linkages with IFCs are both incompatible with available evidence. What other factors might explain this relationship? This section looks at a number of explanations, before settling on the issue of transaction costs as the most important. 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 PRC (e.g. Hong Kong, Taiwan, etc.), those within the PRC, and foreign investors.

One factor peculiar to China's recent development is the special position of the Republic of China-Taiwan. Since the end of the Chinese Civil War between Communist and Nationalist forces in 1949, relations between China-PRC and China-ROC have waxed and waned, but there have been imposing barriers to economic relations between the two. As Taiwan accumulated a stock of capital looking for profitable overseas opportunities and China opened up to the world, the complementarities between their economies became more pronounced. Because direct economic relations were prohibited, they increasingly took place indirectly. Until 1982 the natural intermediary was Hong Kong. But the decision in that year that Hong Kong would be returned to China stimulated the search for alternative locales. The regulatory flexibility and tax-neutral environment of IFCs made them a natural solution. The hand-over decision also prompted a huge wave of redomiciliation, as both companies and individuals from Hong Kong sought asset protection in IFCs, including Bermuda, the British Virgin Islands and the Cayman Islands. Indeed, the British Virgin Islands is so synonymous with IBCs that in Hong Kong these are often referred to simply as 'BVI's'.

Even putting worries about the status of Hong Kong to one side, there are good reasons why Taiwanese and other investors might prefer an IBC to a Hong Kong company. Hong Kong companies must file annual accounts and be audited; IBCs typically do not. IBCs make capital reduction easier. Hong Kong companies must pay stamp tax, whereas IBCs do not. IBCs are

quicker and cheaper to establish than a Hong Kong company. For these reasons the large majority of companies listed on the Hong Kong Stock Exchange are incorporated in the Cayman Islands and Bermuda, with Jersey and the British Virgin Islands providing other alternatives. By providing a convenient and low cost intermediary for Taiwanese capital to flow into the mainland Chinese economy, IFCs have made a significant boost to the latter's economic growth.

Apart from the special situation of the division across the Taiwan straits, there are a number of other features that distinguish inward Chinese FDI flows. One of these is the unusually high proportion invested in real estate, around a quarter of the total, once again disproportionately coming from IFCs. The suggestion here is that this represents a kind of remittance. Overseas Chinese in the diaspora send money to China in the form of real estate investments held by IBCs. This relates to the issue of capital flight from developing countries raised earlier. But putting this issue to one side, there is good reason to think that IFCs provide a good half-way house for private individuals and firms looking to safeguard their wealth, and national governments looking to mobilise domestic capital for national development.

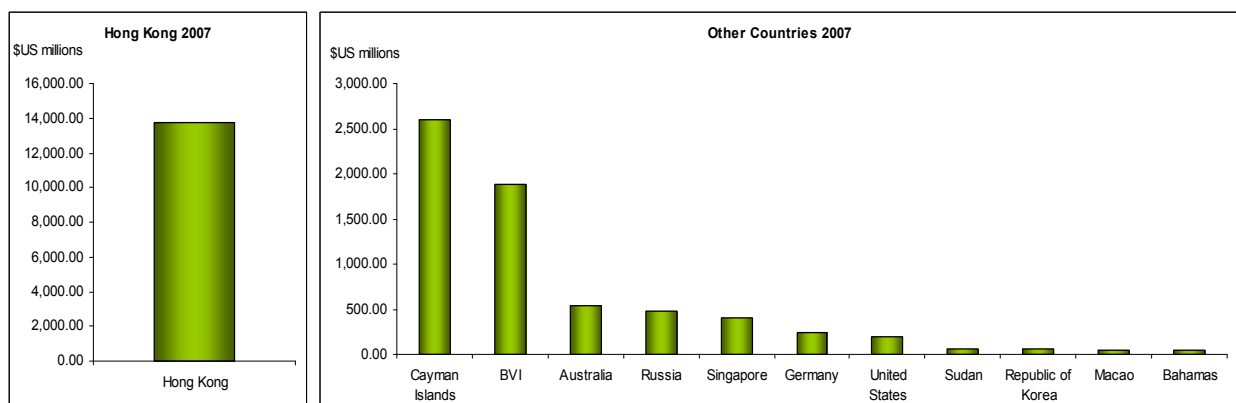
With regards to private wealth, the logical alternative to round-tripping is not leaving the money at home, but instead sending it out as a one-way flow. Clearly, money from elites in developing countries that is sitting in a bank account in Paris or London is not doing anything to foster development at home. Round-tripped money, in contrast, is by definition returned to be invested in the country of origin. Much of the discussion of capital flight ignores the fact that, in the words of Henry Kissinger, paranoids have enemies too. It is unclear why even in moral terms citizens ruled by a dictatorial, predatory government should not put their money out of range of confiscation.

Given the recent history and contemporary record of extreme violence and economic predation practiced by governments against their citizens, it ill-behoves critics comfortably situated in rich, stable, Western countries to cast aspersions against those in the developing world seeking to safeguard their families' savings. Even when governments of developing

countries are observing human and property rights, circumstances can change, and past violations may leave deep-seated insecurities (consider the lingering effect of the economic collapse of the 1930s on the German mindset). Given these factors, it is unreasonable to blithely ask those in developing countries to put their faith in leaders like Obiang, Mugabe, Ahmadinejad and Than Shwe. Invoking the shield provided by IFCs to re-badge private domestic wealth as foreign assuages worries about confiscation, while making this capital available for stimulating domestic growth.

Even more important than providing reassurance to private wealth, however, is the idea of IFC-intermediated foreign investment reducing transaction costs, and contributing to ‘capital augmenting’ investment. Sutherland and Matthews (2009) in particular see the bulk of capital flows between China and IFCs as representing real value-adding for the Chinese economy, particularly in the form of raising capital overseas, which is then channelled back into the domestic economy. This provides an answer for why the Cayman Islands is by far the largest recipient of out-bound FDI from China after Hong Kong (see Table 6). Using firm-level data from 72 Chinese-controlled corporations listed on the New York Stock Exchange, it is argued that the ease of incorporation in the Caymans (taking 2-3 days), but even more the compatibility of Cayman companies with listing requirements on both the New York and Hong Kong stock exchanges is crucial. In turn, this means that listing can take place in the market that will provide the highest valuation.

Table 6: Leading FDI destinations from China 2007



Source: National Bureau of Statistics of China, *China Statistical Yearbook (2008)*.

A memo from Fenwick & West spells out the logic of such an operation (2008). Significantly, the issue of exploiting a tax differential between foreign and domestic investment receives no mention at all. The value-added of a Cayman firm involves Chinese companies that are looking to attract foreign, especially US, investors for an Initial Public Offering or acquisition. The structure at its simplest involves listing a Cayman Islands holding company in the United States or Hong Kong, with a wholly-owned Chinese subsidiary as the operating company. Typically, however, the firms listed on US exchanges further interpose a British Virgin Islands company in between the Cayman listing vehicle and the Chinese operational subsidiary (see Figure 1; a much more complicated versions are shown in Figure 2). Such arrangements are especially favoured by Chinese technology and internet firms, including Actions Semiconductor, Baidu, China Medical Technologies and Focus Media.

Figure 1: *'Round Tripping' or 'Capital Augmenting' OFDI? Chinese outward Investment and the Caribbean Tax Havens*, D. Sutherland, D. and B. Matthews (2009).

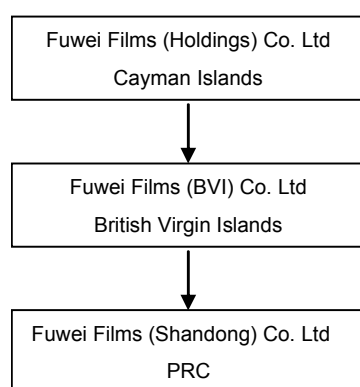
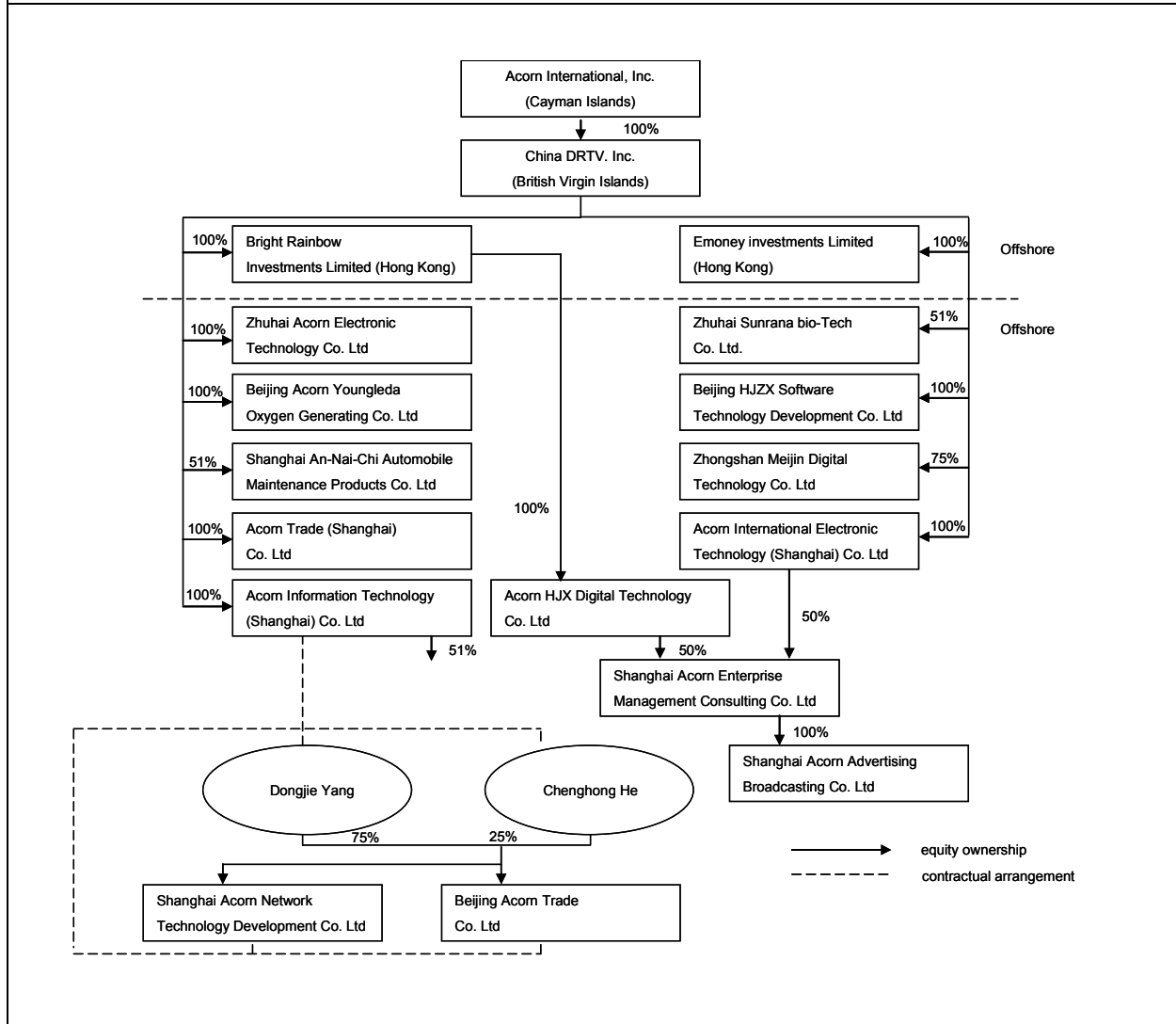


Figure 2: 'Round Tripping' or 'Capital Augmenting' OFDI? Chinese outward Investment and the Caribbean Tax Havens), D. Sutherland, D. and B. Matthews (2009).



Given that asset protection is not the goal in this situation, the most obvious question might be why leave China at all if this is both the ultimate source and destination for the capital in question? The first answer is that currency restrictions prevent the easy transfer of foreign currency into and out of China. Thus for complicated operations where it is hard to predict future foreign currency needs, it is much more advisable to keep foreign currency outside the

country. Secondly, Chinese procedures provide less flexibility in terms of share issuance. In China only one class of stock is allowed for foreign invested firms. In IFCs like the Caymans, however, both common and preferred stock can be issued. The latter allows for so-called Value Adjustment Mechanisms, according to which if a firm does not meet pre-agreed financial benchmarks the preferred stock is converted into a greater sum of common stock (Ellis and Styles 2007). Bringing up a less technical but equally important concern, the Fenwick memo notes 'For employees, stock options need to look and feel the same as those of a US corporation' (2008: 2). This issue of being comfortable with the 'look and feel' of the corporate arrangements is especially relevant to BVI companies, which have now become the norm in greater China. After the increased requirements of the Sarbanes-Oxley Act Chinese IPOs are increasingly conducted through Hong Kong, but the same advantages apply.

Aside from allowing timely incorporations, a Cayman company provides more flexibility in amending the company charter, while both establishment and recurring registration fees are lower than in other jurisdictions. It should be emphasised that the tax-neutral environment provided by the Caymans is important, but not in the sense of avoiding or evading tax due in China or any third country. These advantages of tax neutrality and corporate flexibility are common to many IFCs located in large and small companies. It is to be stressed that the division between parent and subsidiary companies is not just a matter of form, but must be matched by substance also on the basis of the 'arm's length' provision. This includes setting up sales agreements between the different companies within the structure, concluding licencing agreements for any intellectual property that is shared, and avoiding any co-mingling of bank accounts.

These firm-level data shed important light on the otherwise puzzling flows between China and IFCs. First and foremost, they provide an explanation as to why even round-tripped money from China is value-adding, or capital augmenting (Sutherland and Matthews 2009). It allows Chinese high-tech companies in particular to efficiently access foreign investment to funnel back into China via IFCs to further the country's economic development. The flexibility and sophistication of IFCs, as well as their tax-neutral environment, provides features and

services simply not available in China. Second this version explains the predominance of the Cayman Islands as a destination for Chinese outbound FDI (as Cayman companies serve as the listing vehicle), as well as the similar prevalence of the British Virgin Islands on the in-bound leg (as the BVI company mediates between the Caymans and Chinese firms in the structure). Finally it explains why out-bound and inward flows to IFCs do not cancel out: capital sent to the Caymans comes back mixed with foreign capital raised in the US and Hong Kong stock markets.

Investments by hedge funds and private equity firms are likely to be from IFCs simply by virtue of the fact that a large majority of such vehicles are domiciled in IFCs like the Cayman Islands, the British Virgin Islands, and the Channel Islands. Another possibility is when more than one outside concern wish to engage in a joint venture in China. Here the common procedure is for each partner to form an IFC-based company or trust to hold a Chinese operating firm. Such a structure provides each of the partners with reassurance concerning the governance of the overall structure, which can be handled in more sophisticated courts should disputes arise. This again testifies to the importance of institutions in reducing governance-related transactions. Any country that shuts itself off to IFCs will necessarily shut itself from investment from these kind of vehicles and arrangements.

A further applied example is that of the relationship between the Asian Development Bank (ADB) and Credit Oriented Group Limited (COG), once more mediated using an IFC (the Cayman Islands). This case is particularly significant given the explicit development mandate of the ADB. COG and its subsidiaries guarantee loans made to small and medium enterprises in China. As the relevant ADB report explains: 'the development of SMEs [small- and medium-sized enterprises] is an important engine of growth and a key contributor to poverty reduction by creating employment, increasing individual incomes, and generating tax revenues in the PRC' (ADB 2007: 1).

The biggest problem that such enterprises face, however, is the lack of access to financial services and capital. The large state-owned banks prefer lending to similarly-sized state-

owned enterprises. Commercial banks offer relatively unsophisticated products, are highly risk-averse, and thus impose high collateral requirements which effectively bar Chinese SMEs from accessing adequate funding. Foreign financial firms that could plug the gap are generally excluded from the Chinese market. Finally, interest rate ceilings imposed by the People's Bank of China on lending institutions mean that it is generally uneconomic to extend loans to relatively higher-risk borrowers like SMEs. A World Bank report confirms that skewing of available credit to large, particularly state-owned, enterprises at the expense of smaller firms exacerbates income inequality (Ravallion 2009: 9). Stock market listings within China are generally closed to smaller private enterprises, instead being reserved for larger and politically better-connected firms. To help remedy this situation the ADB provided \$10 million and then an additional \$3 million to COG so it could guarantee loans to smaller firms, and thus free up the flow of capital to the concerns that are key to poverty reduction in China.

As with the discussion above, The IFC connection is that COG itself is incorporated in the Cayman Islands, despite its Chinese provenance and operations. The ADB's explanation of the rationale for this structure is highly revealing:

The Cayman Islands' legal system is based on British law, and therefore the legal concepts are familiar and acceptable to international investors... Most PRC companies seeking a listing on the Hong Kong Stock exchange incorporate their listed companies in the Cayman Islands. ADB's external counsel and COG's external counsel have confirmed that, in the present circumstances, a direct listing of COG as a PRC company is not feasible, as listing would involve... a highly bureaucratic process, which is why PRC companies tend to use offshore jurisdictions... the Cayman Islands is generally considered desirable because (i) the legal requirements regarding capital reduction and the distribution of capital are less complicated than are those in Hong Kong, (ii) Hong Kong stamp duty is not chargeable for share transfers that take place prior to the IPO, and (iii) the Cayman Islands are FATF compliant and not on OECD's tax haven blacklist (ADB 2007: 5).

Just as notable as the positive rationale for using an IFC in this manner is the reason that is not adduced: there is nothing to do with escaping Chinese tax obligations. Although a more general discussion of the potential for IFCs to stimulate development is left until the conclusion, it is worth considering the wider applicability of this approach. Relatively unsophisticated large banks, perhaps state owned, are reluctant to provide adequate capital to just those smaller firms that are most important in reducing poverty, and providing tax revenue. International capital, using the flexible products and sophisticated skills available in IFCs, can help to ameliorate this capital shortage and thus drive development.

The status of SMEs is worthy of further consideration. Another particular feature of FDI into China is the tendency to be disproportionately channelled towards smaller firms, rather than the typical profile whereby FDI is mainly the preserve of large firms. Why is this the case, and what are the broader implications? One intriguing answer suggests an account premised on out-flanking high domestic transaction costs by venturing offshore (for a general discussion of FDI and transaction costs see among other Buckley and Casson 1998).

The idea of transaction cost economics came to prominence with the work of economists Douglass North and Oliver Williamson (North won the Nobel Prize for his work on this subject in 1993, Williamson in 2009). Conventionally, economists believe that individuals should specialise to produce what they are best at and trade (i.e. transact) with others to get everything else. Institutions are generally not considered important. To simplify greatly, North and Williamson complicate this conventional version, by holding that transacting may be expensive, and thus that specialisation and trading may not in fact be optimally efficient. Transacting can be expensive for two reasons: either because it can be costly to enforce contracts (governance costs), or because it is costly to set up deals and measure the value of what is being traded (measurement costs). For example, if parties to a deal do not have a common language, this will raise transaction costs and make it less likely exchange will occur (measurement costs). Or if contracts are not reliably enforced, high governance transaction costs might again lower the volume of exchange (governance costs).

If either or both kinds of transaction costs are in play, institutions become important in determining how high or low these costs will be. Low transaction costs facilitate specialisation, exchange and rapid growth, whereas high transaction costs favour autarky, self-sufficiency and slow growth. Both North and Williamson argue that transaction costs not only explain the shape of contemporary capitalism, but are also the most important factor in explaining development successes and failures (North 1990; Williamson 1975, 1985). High transaction costs resulting from a lack of institutions, or bad institutions, retard development, whereas the low transaction costs provided by well-adapted institutions facilitate development and poverty reduction.

How might the issue of transaction costs relate to China, IFCs and development? Boisot and Meyer (2008) argue that exchange within China is characterised by high transaction costs, in some cases higher than equivalent international transactions. It may be easier for Chinese firms to conduct international exchanges than domestic, particularly for smaller enterprises. This is contrary to the normal state of affairs (at least normal for rich Western countries), in which domestic exchanges have lower transaction costs than international ones (Witt and Lewin 2007). High Chinese transaction costs are a result of poorly developed local institutions compared with relatively better-developed institutions available internationally. For many Chinese companies then, the point of exporting capital is to benefit from foreign institutions when this capital is re-imported to China.

As well as a process of liberalisation and opening up to the outside world, Chinese reform since 1978 has also been a process of administrative and economic de-centralisation, first to Special Economic Zones and then to provincial and municipal levels of government. This de-centralisation has raised the cost of domestic trade in China (which in any case is difficult because of the country's large size and uneven transport infrastructure, particularly inland). Provincial governments tend to favour local champion firms, and discriminate against other Chinese firms from outside the province. Furthermore, although corporate income tax and intellectual property rights protection are theoretically the responsibility of the national

government, in practice they are administered at the provincial level. As local governments tend to be run like fiefs, this delegation tends to increase transaction costs for domestic trade.

At the same time, deregulation of international trade and finance, and technological progress, have made it progressively easier to exchange internationally. As such 'Chinese firms going abroad are going in search of more efficient institutions' (Boisot and Meyer 2008: 363). In particular, the institutions in question are those 'capable of supporting international operations': the examples given are incorporation and listing. These authors explicitly see round-tripping as the best example of Chinese firms profiting from efficiency-enhancing foreign institutions. Clearly the best of these kind of institutions are found in advanced financial centres, and here we are back to IFCs. The physical distance to the Caribbean is irrelevant, cultural foreignness is reduced by long experience with Cayman and BVI products and the involvement of Hong Kong intermediaries (like Corporate Service Providers). The logic of the foreign search for better institutions tends to favour intangible services, particularly financial services, over physical goods.

Huang also comes to the same conclusion: 'China's success has less to do with creating efficient institutions and more to do with permitting access to efficient institutions outside of China' (2008: 11). In particular Huang is critical of Chinese governance, and its under-developed financial sector. Once again, this suggests an exciting possibility for the developing world more generally. IFCs are characterised by strong and efficient governance (Dharmapala and Hines 2009), and, of course, highly developed financial sectors. Their existence depends upon lowering international transaction costs since almost all of their clientele are foreign. Thus the complementarities between IFCs, China, but also by extension other developing countries, becomes apparent.

INDIA IN COMPARISON

As noted in the introduction, the main focus of this paper is China, but it is productive to make a brief comparison with the Indian experience. This exercise entails an investigation of the Indo-Mauritius relationship. Until 1991 India largely pursued an economic path of self-reliance with little interaction with the outside world. The domestic economy was highly regulated and protected (though less so than that of pre-reform China), and around 60 per cent of India's population lived in poverty. After a balance of payments crisis, and the collapse of socialist economies in the former Eastern bloc, India embarked on a path of reform. Since 1991 India has enjoyed an average growth rate of approximately 5 per cent.

Often there is an assumption that increased tax revenues and greater involvement of the state in social programs will reduce inequality and poverty. Certainly this can be the case, but India is a prominent example of how such programs can also go awry. Significantly, the richest one-fifth of Indians are most likely to have access to subsidised government goods while the poorest one-fifth are least likely to have such access (Ravallion 2009: 21), exactly the opposite of the result that should obtain in an anti-poverty program. Comparatively wealthy and politically-powerful groups have exploited ostensibly pro-poor policies to feather their own nests.

Just as the large capital flows between IFCs, on one hand, and China, on the other, demand explanation, so too do the flows between India and Mauritius. Thus in 2007 direct investment from Mauritius to India was \$11 billion, while over the period 1991-2007 the total was \$29 billion (Norway 2009: 122). Turning to portfolio investment, the IMF's Co-ordinated Portfolio Investment Survey (CPIS) suggests that as of end 2007 Mauritian portfolio investment totaled \$155 billion, with more than 90 per cent of this sum likely to have passed through to India (Norway 2009:121). Clearly movements of this magnitude are unlikely to reflect Mauritian capital as such. Mauritius established an IFC in the late 1980s. Mauritius had had a tax treaty with India from 1983, though the true potential of this treaty only became apparent from the early 1990s. At this time, the confluence of India's opening up to the outside world and the

availability of Mauritian IFC facilities began to facilitate large-scale flows of foreign direct and portfolio investment into India. These have included major investments in infrastructure projects by Western firms, such as General Electric in the energy sector, as well as institutional investment in the stock market. The issue of round-tripping was of primary interest in China, but seems to be much less of an issue in relation to India and Mauritius. According to the Reserve Bank of India, only 2-3 per cent of the capital passing from Mauritius represents round-tripped Indian money (Partha Ghosh 'Legalise FDI Originating in India: RBI', 12 April 2003, <http://www.rediff.com/money/2003/apr/12fdi.htm>).

The vehicle of choice for investment routed into India via Mauritius has been Global Business Companies 1 (GBC1). While these are in some ways similar to an IBC, the big difference is that GBC1s are classified as resident in Mauritius, unlike IBCs which are defined as non-resident and generally forbidden from carrying out business in the jurisdiction in which they are incorporated (the Mauritian Global Business Company 2 is a more direct match-up with the classic IBC in this regard). The logic behind being a Mauritian resident is to benefit from the country's network of tax treaties, especially with India, though increasingly with China also (much of the capital moving between Africa and China goes via Mauritius).

What benefits are provided by the Indo-Mauritian tax treaty? Until 2002, these included concessions on dividend withholding tax for Mauritian entities holding shares in Indian companies. For those with an interest of 10 per cent or more the rate of tax was reduced to 5 per cent, while otherwise the rate was 15 per cent. In turn, dividends transferred to Mauritius attracted a 15 per cent headline corporate tax, but in practice this was either cancelled out by foreign tax credits, or reduced to 3 per cent by a deemed foreign tax credit. For its part, Mauritius did not levy a withholding tax. This advantage was cancelled out in 2002 when India abolished its dividend withholding tax.

The second major tax benefit relates to capital gains tax. A Mauritian company holding shares in an Indian company is exempted from Indian capital gains tax. Because Mauritius itself levies no capital gains tax (and as mentioned above no withholding tax), profits could be

passed back through Mauritius. Once more, however, with the passage of the Finance Act of 2004 in India the tax rationale of this route has become less compelling as Indian capital gains tax has either been abolished or reduced from 30 to 10 per cent (depending on the nature of the transaction).

In sum, therefore, although tax advantages might explain the initial popularity of using Mauritius as a conduit to investment in India, in the period 2002-2004 these tax advantages largely disappeared. Yet since 2004, flows through Mauritius into India have only increased. As is the case with China, the superficial notion that this is a tax-driven phenomenon is a poor fit with available evidence (Moller 2009; Gujadhur Bell 2004).

A better explanation seems to be that third country nationals investing in India have chosen to go through Mauritius to take advantage of the skills and institutions available from the internationally-oriented Mauritian financial sector. This is certainly so relative to the more heavily regulated and parochial Indian finance sector. The large and growing tax treaty network that Mauritius is building provides a rough equivalent to the tax-neutrality afforded in other IFCs. Added to this are the same sorts of transaction-cost-reducing geographical proximity and cultural affinities that Hong Kong enjoys with China. These last may explain why, despite having a very similar tax treaty with India, Cyprus is much less often used by foreign investors in India.

Further evidence for the beneficial nature of the Indo-Mauritius economic relationship, and the tax treaty more generally, is provided by the attitude of the Indian government. Both under the BJP and Congress parties, the government has been broadly supportive of the tax treaty, and indeed has consistently defended it from various court challenges. A former Indian Commissioner of Income Tax mounted a challenge to the decision (Circular 789) of the Central Board of Direct Taxes mandating that Indian authorities accept Mauritian certificates of tax residency. The goal of the action was to invalidate the use of GBC1s as a conduit for foreign investors into India by disqualifying them from the concessions available under the double tax treaty. Although initially successful, this challenge elicited a strong challenge from the Indian government, which appealed the decision in the Supreme Court, winning the case

in October 2003. In defending the double tax agreement so strongly, the government seemingly indicated it was aware of the value of this arrangement in fostering foreign investment in India, and thus the development of the country more generally. On the other side of the ledger, the Vodafone India case dealing with capital gains tax liability (see <http://www.theworldlawgroup.com/docs%5CIndia%20-%20Vodafone.pdf> for details) may limit the ability of local and foreign firms to access efficiency-enhancing institutions in IFCs when investing in India.

What institutions might international investors require that India still lacks? Why do these investors seek efficient institutions outside India? Here a report conducted for the Indian government and led by Percy Mistry on the feasibility of establishing an international financial centre in Mumbai is highly revealing. This report notes that the sort of complex contractual arrangements that characterise contemporary international financial services require correspondingly sophisticated contractual enforcement mechanisms (Mistry et al. 2008: 110). Yet in frank and detailed terms this report spells out considerable shortcomings in the current Indian system. Legislation is often outdated, and imposes rigid, inappropriate restrictions. Policy implementation is uncertain, unpredictable and slow. The court system is again sluggish and ill-adapted to dispute resolution in the context of complex financial relationships (Mistry et al. 2008: 139). State ownership and financial regulations cramp private sector development and competition, as well as introducing conflicts of interest among the regulators, without necessarily providing stability, as evidenced by the 1991 crisis in India (Mistry's subsequent commentary on India's institutional shortcomings in the financial sector and elsewhere have been even more forthright).

Although the report does not use the language of transaction costs, these institutional deficits are just those that raise transaction costs for international financial services. Hence it is easy to see why foreign investors seek to take an indirect route into India, even leaving tax considerations to one side. These investors can marry the economic potential of the huge Indian market with more sophisticated financial institutions in jurisdictions like Mauritius. In the long-term India may well reform its institutions and lower transaction costs to the extent

that renders outside IFCs redundant, but clearly this sort of institution-building is a slow, evolutionary process.

A final question is whether there is any analogue to the value-adding round-tripping by Indian firms in the same manner as occurs in China. Intriguingly, there are signs that Indian firms are choosing to go out into the world via Mauritius, both because of cultural and geographical proximity, and because Mauritius's openness to international financial flows and tax treaties make it an efficient route through which to repatriate profits back to India. But it may be that Singapore will become the main centre for value-adding round-tripping for Indian firms. In 2005, India and Singapore signed the Comprehensive Economic Co-operation Treaty. Since that time, Singapore has become the largest recipient of Indian FDI, while also becoming the second largest investor in India. Indeed, between 2005 and 2009, Indian investment in Singapore has increased 1077 per cent (R.N. Bhaskar, 'Singapore: India's Latest "Round-Trip" Destination', *Forbes India*, 13 October 2009). As well as its extensive network of Double Tax Treaties and Free Trade Agreements, Singapore is well equipped with just the sort of institutions that serve to lower the cost of financial transactions. Although conclusions can only be provisional at this stage, once more this provides an interesting parallel with the Chinese-IFC relationship described earlier.

APRIL 2009 LONDON G20 SUMMIT

The argument advanced above 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 ('tax havens'). Specifically, President Sarkozy (and to a lesser extent Chancellor Merkel) wanted the G20 to endorse the OECD's listing of 'tax havens', released that same day after a phone request from 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. Indeed, sources close to the British side in the hand-over negotiations indicate that their Chinese counterparts were most anxious to preserve

Hong Kong's low-tax environment and international financial services industry even as early as 1982. Current efforts to develop Shanghai as a financial centre again provides testimony of the benefits the Chinese government expects to reap from IFCs in the future, at home and abroad.

CONCLUSIONS

The discussion of China's experience with IFCs, and to a lesser extent India's also, suggests a number of fascinating conclusions regarding the development potential of IFCs for poorer countries more generally. Before systematic evidence is gathered, these conclusions must remain tentative, but certainly the existing explanations of the relationship between developing countries and IFCs are radically incomplete. Although any large financial flows will probably include some illicit funds, major OECD economies provide a far more amenable resting place for wealth stolen from developing countries than do IFCs. 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.

As conceived by institutions like the World Bank and the IMF, under-development and poverty are above all problems of deficient institutions. Governments may be weak or corrupt, contracts and property rights insecure, and the infrastructure necessary for the exchange of goods and services and capital-raising lacking. The intellectual link between an institutional deficit and poverty is provided by the idea of transaction cost economics, which holds that, in the absence of efficiency-promoting institutions, high governance and measurement costs may militate against specialisation, trade and therefore economic growth. 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.

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 in this paper suggests that there is much to be gained by developing countries cultivating closer relations with IFCs to foster growth and reduce poverty.

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