

The Anglosphere Beat: Regulatory Arbitrage

By James C. Bennett

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WASHINGTON, Aug. 18 (UPI) -- Two weeks ago I had the novel experience of being a witness at a U.S. federal securities fraud trial. A group claiming to be an investment organization raised many millions in a complex structure that turned out to be, at its heart, a Ponzi scheme.

Most of the funds seem to have been siphoned off or otherwise diverted, but some amount was invested in legitimate enterprises, particularly in the Internet transactions area, probably to add a color of legitimacy to their plan. My company was one of the latter. I was called upon to verify some information regarding the transfer of funds from the defendants' organization into our account for the purchase of shares.

In the course of my mostly tedious testimony, a side discussion arose about some comments on my company's website about the economic phenomenon of "regulatory arbitrage". The assistant district attorney began to wax poetically to the jury about how this development would lead American business to be regulated "by Tonga".

Ironically, while an obscure functionary of the Justice Department was indulging in flights of rhetorical fancy, the people actually in charge of U.S. economic policy, starting with the Treasury Secretary Paul O'Neill, have continued to defend America's position as one of the world's great winners from regulatory arbitrage.

Despite all the recent rhetoric about Bermuda incorporations and offshore tax havens, the fact of the matter is that America is the world's greatest offshore tax haven, and profits greatly from it.

Arbitrage is the economic practice of taking advantage of a difference in price of the same good or service in two different places. An arbitrageur buys in the cheap place and sells in the expensive place. The game is to see whether the transaction costs of buying and selling can be kept low enough to make a profit from the price difference.

Regulatory arbitrage is a subset of this practice. In particular, it looks to take advantage of places that are more economically efficient (and thus produce better and/or cheaper goods and services than over-regulated places) and make their goods and services available in

less efficient places.

The Internet obviously lowers the transaction costs of this kind of regulatory arbitrage, and, if it can be organized properly, will make much more of this possible in the future.

Some people fear that worldwide regulatory arbitrage will create a race to the bottom, with economic activity gravitating to places where anything goes.

This ignores the fact that some regulation is beneficial to economic activity. Otherwise big financial firms would base their offshore operations in places like Barbuda or Nevis, which effectively have complete banking secrecy, rather than Bermuda or the Cayman Islands, which do not.

Additionally, the fact that cases in Bermuda or the Caymans have ultimate legal appeal to London (since they are still British Dependent Territories) make them more, rather than less desirable. Regulatory arbitrage drives toward an optimum level of regulation, not a minimum one.

America is not in the top ranks of world taxers and regulators (taxation being viewed as a special case of regulation), but rather in the middle ranks, in general. Continental Europe and many other nations are substantially higher taxers.

Thus Continental Europeans, Latin Americans and many others worldwide find the United States to be a welcome tax haven. This has been a not-inconsiderable factor in the inflow of foreign funds over the past decade, an inflow that has balanced America's large perennial trade deficit. Of course, like all great tax havens, America does not require its financial institutions to report earnings to foreign governments, much to the annoyance of those governments.

Of course many American individuals and businesses use regulatory arbitrage to lower their U.S. tax obligations, most through perfectly legal avenues, and some through illegally sheltering income. Those parts of the U.S. government charged with collecting those revenues are as annoyed with Caribbean tax havens as their French counterparts are with America. But they find little support for wider measures from their superiors, and for good reason.

One is that offshore structures are too necessary to the international competitiveness of American businesses to monkey with. Although America is a medium-tax state compared to, say, France or Sweden, it has some particularly harmful peculiarities in its tax code. One of these is its claim to tax worldwide income of Americans and their businesses, a practice no other major nation does.

Thus, American companies who compete worldwide against corporations of other nations are at a major disadvantage. Over the past 40 years, they have used offshore incorporation to offset that disadvantage.

The Attorneys General of the U.S., from Robert Kennedy to John Ashcroft, have never moved to limit, for example, American banking operations in the Caribbean, in tacit admission that since our system will not fix the problems with its tax code, it must permit such mechanisms to permit American business to be competitive.

The extension of these relief mechanisms downward to smaller businesses may upset this balance and require to issue to at last be addressed directly. The old Common Law adage of "Legal for one, legal for all" may soon be put to a test.

During the end of the '90s, the European high-tax states had begun an initiative to require all nations to require reporting of financial information to all governments -- essentially making every nation every other's tax collector.

There were two problems with this -- one is that it would have helped oppressive governments harrass exiled dissidents; the other is that it would endanger America's advantage as a tax haven relative to high-tax Continental Europe.

The Clinton administration had been drifting along with this initiative, more out of their general sympathy for transnational government than from necessity. However, Bush's incoming Treasury Secretary, Paul O'Neill, promptly nixed American participation, pointing out that international tax competition (regulatory arbitrage in the tax area) is good for America and good for the world economy.

Particularly in the post-September 11th world, America has an interest in steering as much legitimate international financial activity to venues like Bermuda and the Caymans, which cooperate with America on

critical security matters, and away from the sleazier venues, which do not. Of course, if we really found offshore tax havens undesirable, we could reform the American tax code, which would make us an even more desirable destination for those footloose euros. However, I won't hold out for miracles.

Meanwhile, the next time Paul O'Neill has a chat with John Ashcroft, he should tell him to cool his boys down on the topic of regulatory arbitrage. America has too much at stake in its success.

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