PECC International Conference

Competition among Financial Centers in the Asia-Pacific: Prospects, Benefits, and Costs – Stumbling Blocks or Building Blocks towards a Regional Financial Community?

Westin Chosun Hotel, Seoul, Korea
October 15-16, 2007

DAY 1. Case Study Reports: Vision, Strategies, Roadmap, and Progress

SESSION II. Tokyo & Sydney

Australia's Future as a Financial Exporter – Regulatory Lessons from the Financial Entrepôts

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Other people's money II: Making Australia a supplier of funds management to the world

Part two of a two part report by Lateral Economics

5th July 2007

LateralEconomics

CAPABLE, INNOVATIVE, RIGOROUS

Executive Summary

Australia's funds management industry is – remarkably – the fourth largest in the world. Already managing a trillion dollars in assets and growing fast, it is sophisticated, capable and cost competitive. Government policy – in this case compulsory super – has been an important driver of its growth.

Yet official statistics have less than three per cent of its revenue coming from exports – that is foreigners paying our industry to manage their money.

There is a parallel in our own recent past. In the 1960s we had capable and competitive manufacturing. Government policy too was important in driving it's growth, in this case trade protection.

But while manufacturers and policy makers in Japan, Korea and Taiwan turned their eyes towards world markets with great vigour from the 1960s and 70s on, Australia remained complacent. It took us until the late eighties to reduce protection and start the long and arduous process of learning to export.

In funds management the policy issues are quite different, [1] But the basic story is similar. Exports are always welcome of course – a nice bit of icing on the cake – but we've not pursued them with the single-mindedness of others.

Exporting isn't easy.

A global fund is domiciled in one country, holds assets in other countries and may have investors from several other countries as well. Add the network of bilateral tax treaties to this heady mix and the complexities are enormous.

If we were limited to a single finding from our research – if this report stands for a single proposition – it is this.

> Global funds management should be thought of as a *joint-product between funds management firms and their regulators* (including taxation authorities).

Of course tax authorities and regulators must continue delivering on their central mission – protecting consumers, vouchsafing market integrity and tackling tax evasion and avoidance. But those officials in the countries which most successfully export funds management do this with assiduous attention to the specific needs of their global fund managers.

[1] It should be clear that the stark contrast between the government policy involved in driving superannuation and that involved in driving manufacturing means that there are contrasts as well as parallels in the policy issues involved in exporting – most particularly that compulsory superannuation poses no direct costs on exports, whereas trade protection does.

This is not a rationalisation for tax avoidance or some special plea for favours for global funds managers operating in Australia. Just as we exempt exports from GST (like other countries) so there is a general global understanding here and in other countries that global funds should be 'tax neutral' or 'tax transparent'.

Thus here and amongst our developed world competitor countries, it is accepted that the firms that manage global funds should pay company tax on their profits wherever those profits are earned. On the other hand, the principle of tax transparency calls for *investments* within a global fund not to be directly taxed on account of the domicile of the fund. After all, the returns from the investments will often have already borne company tax at source and will generally bear income tax in the investors' home country.

For this reason, Australia has spent recent years trying to extricate global funds managers from inadvertent taxation. A raft of recent changes to the tax and regulatory treatment of Australian domiciled funds has removed many of the worst problems of unintended tax burdens on Australian domiciled global funds.

However difficult tradeoffs are sometimes required between tax neutrality for global funds and preventing avoidance in our domestic tax system.

The financial entrepôts in the developed world, like Ireland and Luxembourg, have successfully established global financial services centres from far more modest bases than our own financial services industry. They have done so by:

- aggressively courting financial services exporters with low rates of corporate taxation;
- having a radical commitment to tax transparency, if necessary at the cost of anti-avoidance measures like our own 'Controlled Foreign Corporations' regulation; and
- assiduously meeting the industry's regulatory needs – for instance for investment vehicles that optimise tax transparency.

This report argues that, though it may be cost beneficial from the perspective of the national economy, the first of these strategies – direct and discriminatory assistance to financial services exports – is the least important of the three strategies.

While we may never be *primarily* a financial exporter, we can aspire to export financial services far more than we do. And given the natural advantages provided by our base, we can expect substantial increases in exports if we rise to the challenge of the financial entrepôts in the other two respects.

Even if it were to be implemented vigorously rather than in the half hearted manner in which it has so far been practiced, Australia's policy of 'minimum effective regulation' is of little assistance.

It puts little emphasis on the responsiveness of existing regulation and so offers little assistance in optimising tax transparency for Australian domiciled global funds. For this is an ongoing task of responding to emerging problems and seizing opportunities. Consider the contrast offered by the financial entrepôts.

When the European courts held that one of Luxembourg's unique private wealth management vehicles breached the Treaty of Rome, a new regime – the *Société de Gestion de Patrimoine Familial* (SPF) – was developed and introduced in just four months.

Similarly Ireland's regulators worked closely with major global funds and in competition with Luxembourg to produce an innovative regime which is more tax transparent than companies and trusts in specific circumstances particularly related to the pooling of funds – so called Common Contractual Funds (CCFs). Industry figures tell us that with a similar regime Australia would manage billions more in pension assets right now.

It is however a 'chicken and egg' problem that is all too familiar in industry economics. Regulation is, in substantial part, standard setting. And firms and regulators at the forefront of standard setting can gain 'first mover' advantages. The complex regulatory and tax problems faced by global funds are solved first and faster in the financial entrepôts for whom it is 'core business'.

A good analogy is provided by the American State of Delaware – a corporate regulatory entrepôt which has opened up an apparently unassailable lead amongst US states as a corporate domicile of preference. It offers an elaborate regulatory and judicial infrastructure devoted to meeting corporate needs – most particularly the minimisation of regulatory uncertainty. Delaware's jurisdiction comes complete with specialist courts and an enviably deep stock of judicial and regulatory precedents.

In a similar way the financial entrepôts are marketing their own regulatory prowess. Their regulatory structures are not just a set of sovereign commands and protections, but *a value added service* which meets core regulatory objectives while maximising flexibility and minimising uncertainty.

If Australia is to succeed in becoming an exporter of funds management services, tax and regulation must be more responsive to opportunities and developments as they emerge. Our report describes this as a 'co-evolutionary' regulatory regime in which regulators and industry work together on the common goal of improving regulatory and tax competitiveness and optimising tax transparency whilst upholding the broad prudential, consumer protection and anti-tax avoidance goals of regulation.

Despite several years of hard work in helping deliver better tax transparency to Australian domiciled global funds, uncertainty continues to frustrate major investment in Australian domiciled global funds management capability.

When Australian firms receive advice on regulatory or tax arcana – say whether a particular transaction crystallises a capital gain – they are often told 'probably not'. Meanwhile Ireland's regulators answer 'no' with a deep stock of precedents to back them up and/or an ability to deliver regulatory changes where necessary.

Australia should:

- Identify *bona fide*, export-ready funds managers and consider offering them an alternative to the current generic policies that fail to address the specific problems associated with exporting financial services.
- Consider establishing a specialist agency to accelerate deliberations upon the regulation of managed funds and be willing to foster collaborative arrangements between regulators and financial service providers.
- Develop an export culture in government and industry, with a focus on achieving higher recognition and better representation for the Australian industry in Asian markets. We must strive to be recognised as a credible financial centre in the Pacific. Financial services should be accorded a higher priority in trade negotiations - particularly with Asian countries to which we might become a substantial exporter of funds management and funds management expertise. Until we can demonstrate a more energetic pursuit of export orientation these countries will continue to look to other centres.

Finally what is at stake? It is not immediately apparent why, at a time of labour shortages we should prefer the jobs generated in this industry over those already existing elsewhere. On further inspection however finance employees get paid nearly twice as much as others – and even controlling for higher skill levels, finance employees still earn far more.

That helps explain why, from about the time they became major centres of global funds management, both Luxembourg's and Ireland's economic trajectory headed sharply north. Ireland went from being the poor man of Western Europe to being Europe's second wealthiest economy. The wealthiest? In the 1970s when it decided to become a global financial centre, Luxembourg was one of the wealthier countries. Today it's the richest by a country mile.

At any half-decent lunch in the City of London a few decades ago the cabbage was overcooked and the conversation was about cricket. Today's financiers eat their brassica puréed, with seared scallops and a cumin jus, while chatting about the property they own back home in the Auvergne or New England. And they — and the businesses that pay their wages — are wealthier and more successful than ever.

Britain's most lucrative industry owes its dynamism to many things, including globalisation, innovation and the good fortune to be based in an old imperial trading city that sits handily between Asia and the Americas. But there was nothing pre-ordained about London's success as a financial centre: it happened largely thanks to an inspired piece of state intervention 20 years ago that opened the doors to foreign talent and foreign capital.

The Economist, Oct 19th 2006.[2]

We don't mind paying Australian tax. We don't want tax breaks on our profits in Australia. We'll pay the going corporate rate. What we can't live with is the Australian government taking a cut of our investors' money on the way through. Foreigners won't invest with us and we can't build serious capacity to export funds management from Australia if there's even a hint of sticky fingers. If we can't get that certainty, we'll just keep doing it from Dublin.

CEO of a foreign owned Australian fund manager

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[2] Accessed on 25th Jan 2007 at

Other People's Money: Making Australia a financial services exporter

1. *Australia's comparative strengths as a financial centre*

On paper there are good reasons for expecting Australia to be a very competitive centre for international finance. The table below itemises those attributes regarded as desirable for a financial centre – as enumerated by Deloitte, in a review of Ireland's attractiveness for the Irish Government (2004). It then enumerates Australia's strengths relative to Ireland. The scale is the number of stars out of five, with one being bad and five being outstanding.

Table One

Characteristic	Ireland	Australia
Taxation	*****	***
Availability of skilled labour	****	****
Relative cost	***	****
Political stability	****	*****
History and infrastructure	***	****
Access to a large market	*****	***
Strong financial regulation and financial stability	****	*****
Regulatory flexibility	*****	***

Of course, the impressionistic measurements set out above cannot capture the full detail of economic life in the two locations, yet the indicators are highly suggestive that Australia's fund managers should be competitive exporters. All the prerequisites are there as far as Australia's political stability and the credibility and capability of our regulators are concerned. Indeed one substantial pension fund managed from Australia on behalf of an Asian Government agency gave that agency the choice of setting up an entity subject to ASIC's regulatory control (together with the higher costs this would entail) and a lower cost entity without ASIC supervision. The holder of the funds plumped ASIC supervision.[3]

The most important advantage Ireland has over Australia is access to the European Union that its membership of the union brings. This has been crucial in its success, particularly given ongoing efforts within the EU to unify Europe's financial markets.

On the other hand, at least over the longer term we have our own advantages – both small and large. We operate in the Asian time zone, giving us unique advantages in an area that is much less developed than most European markets. Two decades of compulsory superannuation have seen Australia acquire an expertise in funds management for pension provision that is in many respects at the frontier of world best practice, not to mention a population with the greatest *per capita* exposure to managed funds in the world! [4]

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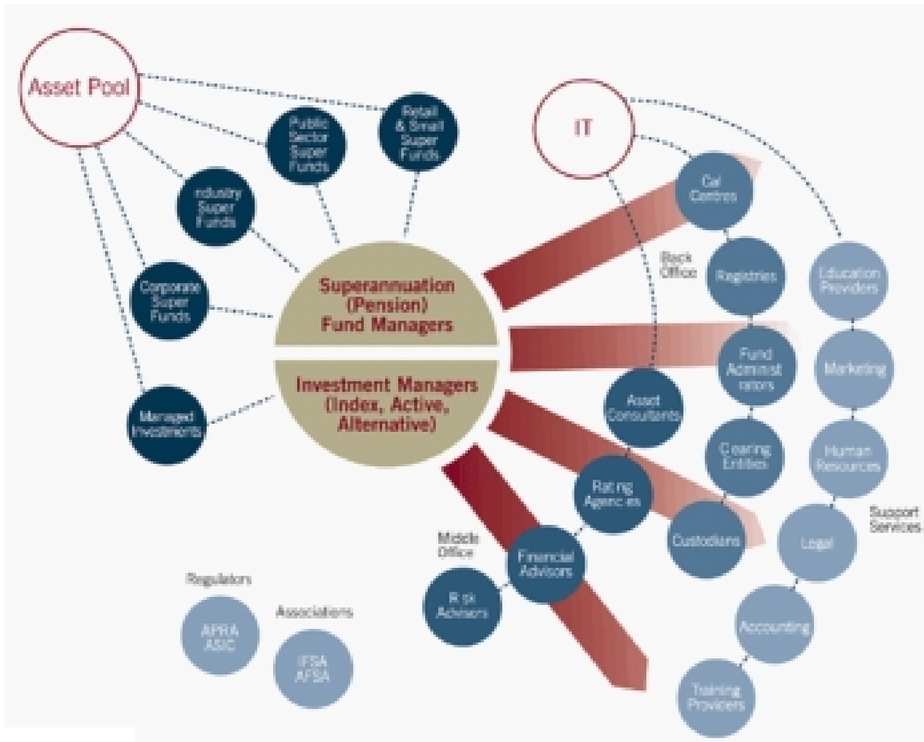
[3] Lateral Economics Interviews with industry, Jan 2007.

[4] A smaller advantage is that our regulators have not shielded the public from hedge funds – as they have in Europe and America (Jacobs and Black, 2006).

Figure One: Australia's Funds Management Cluster



Source: Axiss. [5]

However our industry is remarkably inward oriented, overwhelmingly serving the needs of Australian investors. Even where we are acquiring a reputation overseas – as for instance has Macquarie Bank – this is generally for our growing skill in investing our hoard of superannuation savings in offshore markets, rather than in helping to manage the funds of those in other countries.

It is worth reminding ourselves that financial services can be traded in four basic ways: cross-border trade (where domestic consumers purchase services from a foreign supplier located abroad); commercial presence (where a foreign supplier merges with or acquires a domestically owned institution, or establishes an affiliate, typically a branch or a subsidiary e.g. to exploit an already-established brand); consumption abroad (where domestic consumers purchase services outside the territory of their country); and movement of persons (where foreign persons supply services to domestic consumers in the territory of a country). Cross-border trade and commercial presence are the most common forms of trade in financial services.

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[5] Accessed at http://www.axiss.gov.au/index.cfm?event=object.showcontent&objectid=B3E06210-D9D9-4294-55C7053DD55A3BF3 on 30th Jan 2007.

2. Parallels with the past

In certain respects, the situation in which Australia's fund managers find themselves today is not unlike the situation in which manufacturers found themselves in the 1960s. Much of our manufacturing was capable and sophisticated particularly by comparison with its peers in the region, even if it was not necessarily at the technical frontier. It had grown up partly because of our unique circumstances – as a developed country in a less developed region a long distance from other centres of technical sophistication (conferring a degree of natural advantage). Government intervention had also played its part, particularly in providing protection from imports.

This pattern of government intervention also presented risks to its further development. For just as Asian countries like Japan, Korea and Taiwan were turning the eyes of their industry to export markets, Australian manufacturers preferred the comfort of their protected home market. So when Australia engaged the world in trade negotiation, little attention was given to the idea that we might become substantial exporters in some specialised niches of sophisticated manufacturing.

We thought of ourselves as exporters of primary products and importers of manufactures with lobby groups and political parties largely oriented around the relevant interests. Further, when structural adjustment pressures exerted themselves in the 1970s, political pressures all pointed towards increasing protection for supplying the domestic market, rather than expanding our existing capabilities further into export markets.

Though they are far from exact, the parallels with the state of fund management in Australia today are nevertheless striking. The industry has critical mass and sophistication. Its development has been greatly accelerated by government intervention – in this case compulsory superannuation (which has also conferred a degree of natural advantage on local fund managers). Though financial services are of course mentioned in our negotiations with other countries, they receive far less prominence than export market access for our agricultural products.

Certainly the fact that our industry is not built on protection from offshore competition augurs well for its expansion into exports. However, the rapid and ongoing growth of the domestic market as a result of the continuing effects of compulsory superannuation risks dulling the urgency with which we tackle the transition to export.

3. Outline of the discussion to follow

In the following sections we explore the parallels we have drawn here in more detail regarding the transition to export orientation. Before doing so it is appropriate firstly to document the policy efforts made to date. We will then discuss tax and regulation – surely a critical input into financial services and certainly one we must get right to manage the transition to export orientation. In this context we explore the kinds of policies that were responsible for establishing financial centres elsewhere, with a focus on Ireland and to a somewhat lesser extent, Luxembourg.

It is hoped that, having thus sketched some of the distinctive policy problems of exporting financial services, we can return to the analogy we began with without doing violence to the differences between exporting manufactures and financial services. There follows some tentative suggestions from which might be built the next stage of work, which should lead to concrete policy recommendations.

4. Progress so far

As we discovered with manufacturers, where an industry has grown up predominantly servicing the domestic market, there can be important barriers to export. In the case of manufacturing, tariffs indirectly raised costs for all exporters – by increasing our exchange rate – but also directly (by increasing the costs of inputs). For this reason we introduced schemes like duty drawback remitting tariffs on inputs to export. However they were administratively cumbersome, and did little to establish an export culture, so long as high levels of protection remained. By contrast, as we shall see below, the successful Asian countries were enormously energetic in fostering an export culture throughout their industries. In many ways they liberalised trade *on behalf of* exporters.

In finance there are no tariff barriers to the development of an export culture, but there can be tax and regulatory barriers. In particular, many of our regulatory and tax avoidance measures have been designed in a context in which we did little exporting of financial services. As a result, many measures have been taken that impose taxes on the investments of foreigners and/or otherwise constrain the options of those interested in exporting financial services.

The industry has been active in proposing reforms to remove tax and regulatory burdens to export flows, and the government has responded in ways that are well regarded both by the local industry and internationally. Klein and Seddon of PricewaterhouseCoopers (writing for International Tax Review) commented (2005) that the reforms of the previous five years had "made Australia much more attractive as a jurisdiction for locating holding companies. When the Australian tax system of five years ago is compared to the system that exists today as set out in the table below, it is very clear the extent of reforms as they affect foreign investors." They offered the following table.

Table Two: Tax snapshot – then and now		
	2000	**2005**
Corporate tax rate	36%	30%
Treaty network	Extensive.	Extensive – Recently concluded treaties with the US and the UK reducing withholding tax on dividends, interest and royalties.
Conduit relief for foreign income	Limited – No Australian tax payable on some non-portfolio foreign dividends received by Australian companies where on-paid to foreign shareholders.	Broader – Proposal to create a foreign income account for Australian companies, which should allow most foreign-sourced income (not limited to dividends) to be distributed to non-resident shareholders free of Australian tax.
Inbound capital gains tax	Foreign shareholders subject to capital gains tax on most shareholdings, but treaty relief may have been possible in some circumstances.	2005-06 federal Budget proposes that foreign shareholders should only be subject to capital gains tax where there is a substantial interest in real property.
Outbound capital gains tax	Australian companies were subject to capital gains tax on disposal of shares in foreign subsidiaries.	Australian companies generally only subject to capital gains tax on the disposal of shares in foreign subsidiaries to the extent that the foreign subsidiaries hold passive assets.
Controlled foreign company (CFC) rules	Extensive and complex. Anomalous taxing of income arising from a number of common commercial transactions.	Extensive, but now less likely to result in Australian taxation, particularly for CFCs resident in comparably-taxed jurisdictions. Several anomalies resolved.

Source: Klein and Seddon, 2005.

Further, since that time there have been numerous additional changes seeking to further extricate Australian managed funds from taxation on income streams from foreign owned assets.[6]

[6] Tax Laws Amendment (2006 Measures No. 4) Bill 2006 was introduced into Parliament on 22 June 2006. This Bill implements the Government's 2005-2006 budget announcement and has two main features. First, it narrows the range of assets on which a foreign resident is subject to Australian CGT to real property and the business assets (other than Australian real property) of Australian branches of a foreign resident. Second, the integrity of the narrower CGT tax base

To explore what arrangements might improve the 'export friendliness' of our tax and regulatory structures as they affect financial services, we briefly discuss the nature of regulation itself. We argue that though the current focus on 'minimum effective regulation' is a helpful principle in the appropriate contexts, it is not particularly helpful in addressing the question of regulatory responsiveness. We argue in subsequent sections that regulatory responsiveness appears to be one of the characteristics of successful global financial centres and that it is one we should seek to emulate.

5. The inevitability of regulation

Both here and abroad, business activities are becoming progressively more regulated. This is self evidently true in finance (see below) and, at least by the crude measure of the volume of regulation on the statute books, is true more generally.

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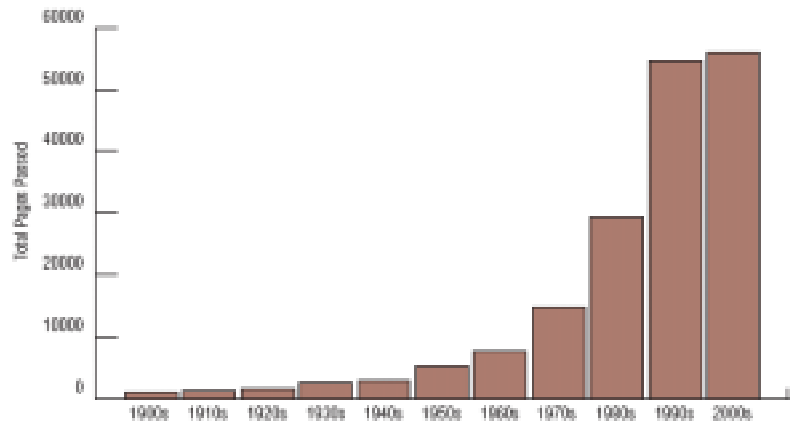
is strengthened by including rules covering indirect holdings of Australian real property by foreign residents.

Tax Laws Amendment (2006 Measures No. 1) Act 2006 received Royal Assent on 6 April 2006. In part, this Act implements the Government's 2005-06 Budget announcement to exempt from income tax the non-wage foreign income (and equivalent capital gains) of people here on temporary entry visas who are first-time tax residents of Australia for a period of four years.

Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005 received Royal Assent on 14 December 2005. In part, this Act allows an Australian company that receives foreign income to pay dividends to foreign shareholders free of Australian tax.

These details are excerpted from the Treasury's webpage updating the ongoing results from the Review of International Taxation Arrangements. Accessed on Jan 1st at http://www.treasury.gov.au/content/int_tax_review.asp?ContentID=760&titl=Review%20of%20International%20Taxation%20Arrangements

Figure Two. Pages of Australian Government primary legislation (estimate)



Source: Regulatory Taskforce, 2006, p. 5

It appears that our current 'regulation review' measures – which focus on 'gatekeeping' to prevent excessive regulation being passed – have enjoyed limited success. This has also been the case in other countries (Fiorino, 1997)

In the context of this review we think it is worth posing the question 'is less regulation always better?'

Firstly, arrangements which most would accept have somewhat rationalised our regulatory arrangements and improved their quality – such as the reforms following the Hilmer and Wallis reports – have done so at the expense of hundreds of additional pages of regulation! So the mass of regulation may grow – as software programs grow – as a result of increased functionality and/or attention to quality and detail.

Secondly, if regulation is inevitable and it is complex – as much regulation is – then it is important for it to be responsive. As we argue below, some of the most responsive regulators are those in the most successful financial centres – and responsive regulation frequently involves more, rather than less regulation. The need for responsiveness is demonstrated even more clearly when we consider what we call 'regulatory dovetailing' in a subsequent section.

Funds management seems to be a paradigm case of an industry in which extensive regulation is so inextricably tangled up with the industry that it should be regarded as a 'joint product' between service providers and regulators. A worthwhile analogy arises with information and communication technologies, where individual firms compete with each other but do so within the context of common standards which are often provided collectively.

A recent study illustrates the significance of this issue for finance relative to many other areas of goods and services. In a study of the competitiveness of four of the great financial centres of the Western world (London, New York, Frankfurt and Paris) three of six attributes of competitiveness relate to regulation – the competence, responsiveness and light handedness of regulation or regulators – with the other three being skilled labour, tax and attractive living and working (Deloittes, 2004, p. 33).

More recently, in an attempt to improve the regulation of risk management, concern about the financing of terrorism and corporate scandals both here and in the US has unleased what Deloitte called a 'tidal wave' of new regulation.

Table Three: Recent developments in the regulation of finance since 2000

Area	Regulations	Detail
Capital adequacy	Basel II, EU Capital Adequacy Directive, Insurance Directive	New capital adequacy regulations are being introduced to help prevent against corporate failures. E.g. Basel II (due to come into force by the end of 2007) focuses on the amounts of capital a bank will be required to set aside in order to carry out different type of business (operational/credit risk assessment). Although it only applies to banking, it influences other sectors by influencing regulators viewpoints.
Corporate governance	Sarbanes-Oxley, Turnbull Review, Financial Conglomerates Directive, IAASA	Across the globe, the movement towards improved corporate governance is gathering pace with an unprecedented number of initiatives undertaken or planned for implementation over the coming years. In the US the Sarbanes-Oxley Act will drive tougher and more transparent financial reporting and disclosure in public companies operating in the US. Furthermore, it will significantly influence legislation in other countries.
Anti money laundering	Patriots Act	Anti money laundering legislation is focusing organisations on the need to be wary of unusual transactions. In the US, the Patriots Act 2001 requires suspicious transactions of $5,000 or more to be reported adding to the administrative burden. Financial reporting standards continue to be reviewed and
Financial reporting	IFRS	updated. In particular the drive towards a unified set of accounting standards continues. This is not merely an accounting issue but extends into systems and management information matters.

Source: Deloittes, 2004, p. 22.

6. Small is beautiful – the virtuous circle of successful financial entrepôts

It is noteworthy how many major exporters of financial services are small country financial entrepôts. To some extent Switzerland has been in this category for over a century – as banker to the wealthy of Europe and now the world. Financial entrepôts to emerge since Switzerland include Singapore and

Hong Kong from the 1960s on in Asia, and Luxembourg from the late 1970s and Ireland from the late 1980s in Europe.

Box 1. Luxembourg becomes a global financial centre

While among the smallest EU countries, Luxembourg's successful policies have given it a reach that extends well beyond its borders. Following the steel crisis of the 1970s, Luxembourg managed the transition to a financial services-based economy because of its (i) advantageous tax and regulatory regime; (ii) early financial market liberalization; and (iii) responsible financial policies. These policies generated a virtuous growth cycle in the "golden 1980s and 1990s," permitting the public sector to accumulate substantial wealth. Relying to a considerable extent on foreign labour and capital, this growth steadily raised the country's profile in the global financial system. Luxembourg's international banking industry is comparable in size to those of Hong Kong . . . and Singapore, while its investment fund industry (IFI) has become the second largest worldwide.

Source, IMF, 2006.

From an early stage in their development as a financial centre each of these countries has actively courted the role of financial entrepôt. In some countries – such as Ireland – tax breaks have been important in establishing the centre in the first place.[7] But even here over time Ireland was able to augment its competitiveness with critical mass as policy makers focused on a regulatory/tax mix suited to financial services exports. Today none of these financial entrepôts are low-cost locations, each having high wages and high property prices (in part as a result of their success as financial services exporters).

As is illustrated below, regulators of financial entrepôts often understand their role in the context of competition with other financial centres. A close analogy can be drawn with the competition for corporate charters between states of the US (see Box 2 below).

[7] Though the low corporate tax rate of 10 per cent was an important part of its success, it was an equally important part of the Irish strategy that it not be seen as a tax haven. This was not just to avoid friction with Brussels but also because throughout the world, countries' impose withholding taxes on income paid to foreigners – which taxes are reduced where reciprocal tax treaties exist. See eg. Jennings, John, 1997. "For Ireland's IFSC - the road is still rising to meet it." 17 March 1997, National Underwriter Property & Casualty-Risk & Benefits Management Edition, accessed via Factiva.

Box 2. Delaware: regulatory services entrepôt

It is instructive to add one further location to the list of entrepôts, though here the entrepôt is in corporate law and regulation rather than finance.

Amongst American States, Delaware is relatively small but over the twentieth century it established itself as a major exporter of corporate governance services. In effect it sells its regulatory services to US corporates. In return for franchise fees to domicile their corporation in Delaware – they are typically higher than those of other states – American corporations gain access to what Roberta Romano describes in the following terms.

> Delaware offers a superior product, including a substantial stock of legal precedents, expert judiciary and administrative services and a commitment to continued statutory responsiveness.

Firms typically locate in Delaware when contemplating substantial corporate restructuring particularly where there is uncertainty as to the effect of other states' regulations. Some argue that Delaware's competitiveness in regulation is a symptom of a 'race to the bottom' in corporate governance with Delaware privileging the interests of managers over shareholders. However if this were the case one would expect changes of domicile in Delaware to be accompanied by reductions in share prices (as shareholders lose protections available in other states). Econometric research finds no such effect – if anything the opposite.

See Romano, 1993, p 1909, Romano, 2002, pp. 6, 8, 76, Romano, 1985, p. 226

Given the complexity of regulation, and indeed of other countries' tax and regulatory structures (see below), tax and regulatory policy will often involve difficult tradeoffs. Most particularly, governments have tax and regulatory objectives to raise revenue, prevent tax avoidance and deliver various safeguards for their own nationals that they have no reason to extend to foreigners. Yet it will often be difficult to quarantine foreigners from such action. Of course sometimes Australian regulation is valued by foreigners – as for instance in the example above, where a foreign super fund happily accepted ASIC supervision of the management of its pension fund in Australia. Australia's potential as an exporter of funds management services must be built on a foundation of sound domestic regulation. Beyond this, however, tax and regulatory requirements can operate to raise costs and produce undesirable and unintended consequences which can close off export possibilities in the face of competition from others 'getting it right'.

Thus, there are usually important trade-offs between preventing domestic tax avoidance (particularly by use of offshore tax vehicles) and ensuring that such measures do not catch in their net foreigners to whom one is exporting *bona fide* financial services. Those trade-offs will differ depending on the relative size of financial exports compared with financial services supplied to the domestic market and compared with the size of the economy generally.

In particular, domestic authorities may introduce tax or regulatory requirements to counter tax avoidance. Some of these, such as regulation to prevent the use of foreign tax havens can end up obstructing and/or taxing the activities of foreigners who are legitimately seeking to purchase (ie import) financial services from another country. Where the financial services industry is not particularly export oriented, this is of minor political importance. As a consequence, the expansion of financial exports is suppressed, but there is a limited political constituency to raise objections and the domestic industry gets on with servicing the domestic market.

By contrast, in a financial centre with substantial exports there will be much more political pressure on the government to regulate in ways that do not obstruct legitimate export activity. The effect will be strengthened in a financial entrepôt where financial exports expand to become an indispensable component of the country's balance of payments.[8] Thus Ireland for instance has no controlled foreign corporation regime as Australia and many other countries have established to tackle tax avoidance using offshore tax havens. Presumably there is a case for doing something like this in Ireland, but it is outweighed by the potential cost to Ireland's financial services exports.

And as we shall see in the subsequent section on 'regulatory dovetailing', the presence of financial exporters provides regulators with feedback and intelligence about market developments which can be used to design regulatory innovations to capture further export market share.

As the financial centre's exports expand, a virtuous circle is thereby set up. Where fiscal exports are substantial, tax and regulatory proposals that impede exports will encounter political opposition, particularly if financial exports loom large as a source of export revenue for the country as a whole – as they do for financial entrepôts. In that case, nothing will be done that will seriously jeopardise financial exports. Investors in the financial centre know this. The financial entrepôt has the ultimate credibility with investors in the financial centre, for once firms have invested in a location, they are always hostage to opportunistic behaviour from their host country. If they invest in a financial entrepôt they know that the centre, and if it is not large, the country in which it is

[8] Haggard makes a somewhat similar point about country size and the political economy of reform (1991, p 30).

located, is also hostage – if not to the success of the investing firm itself, then at least to the industry of which it has become a part.

Box 3. On the stability and credibility of Ireland's tax and regulatory structure

Q: You wouldn't be concerned if a more left-wing government was elected?

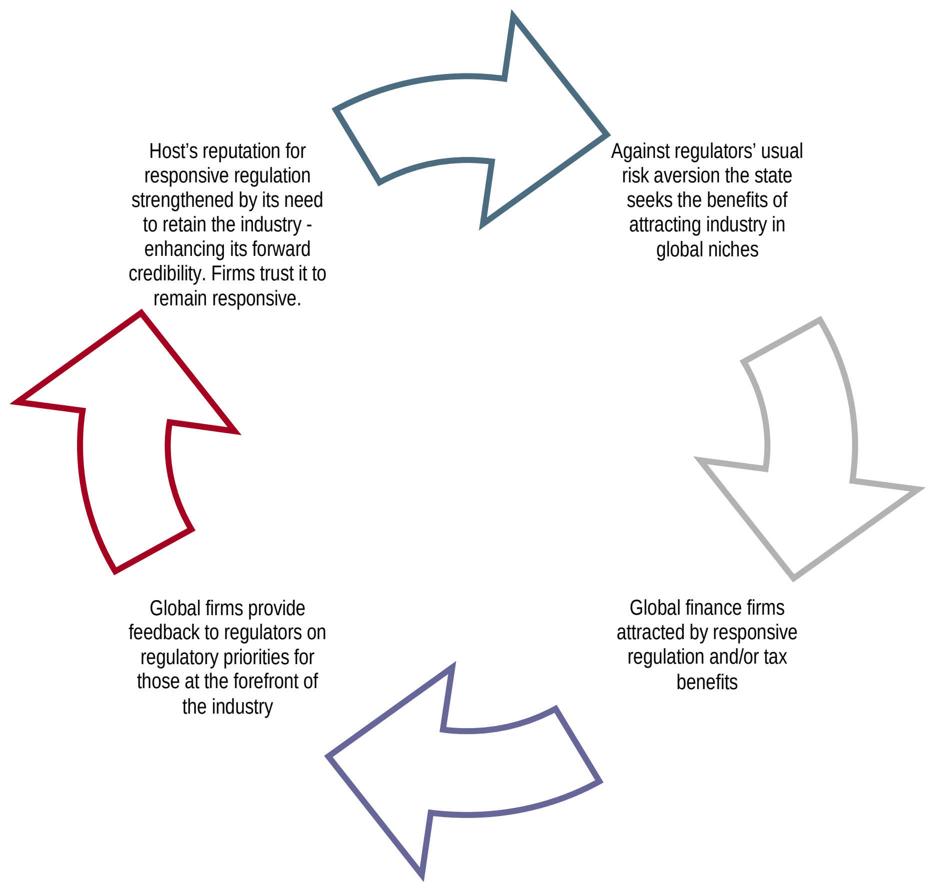
I think that everyone in Ireland is very aware of the role of foreign direct investment and of the success of the current regime and, yes, our business survey confirms that our members are confident the government and the political parties in Ireland are very supportive of the current tax regime, because it is so central to Ireland's success.

Fraser Logue, director of operations at the Irish subsidiary of Abbott Diagnostics and 2006 president American Chamber of Commerce in Ireland cited in *International Taxation Review,* March, 2006.[9]

These ideas on the virtuous circle of tax and regulation in a financial entrepôt are illustrated in the following diagram.

[9] While these comments are made about tax, they would apply equally well to regulatory matters. Accessed on 30th January at http://www.internationaltaxreview.com/includes/specialfeatures/PRINT.asp?SID=616508&ISS=21458&PUBID=224 (subscription required).

Figure Three: the virtuous circle of tax and regulation in a financial centre.



7. The costs of exporting funds management

We mentioned above that, though tax incentives were important in the establishment of Ireland as a financial entrepôt, Ireland and other recognised global financial centres were now high-cost locations. Table Four below shows the costs of living – and so to some extent the cost of purchasing inputs to service provision in various great cities of the world. The number of financial centres in the list is notable, with Sydney – easily our most expensive city – falling well below others including Dublin on the list.

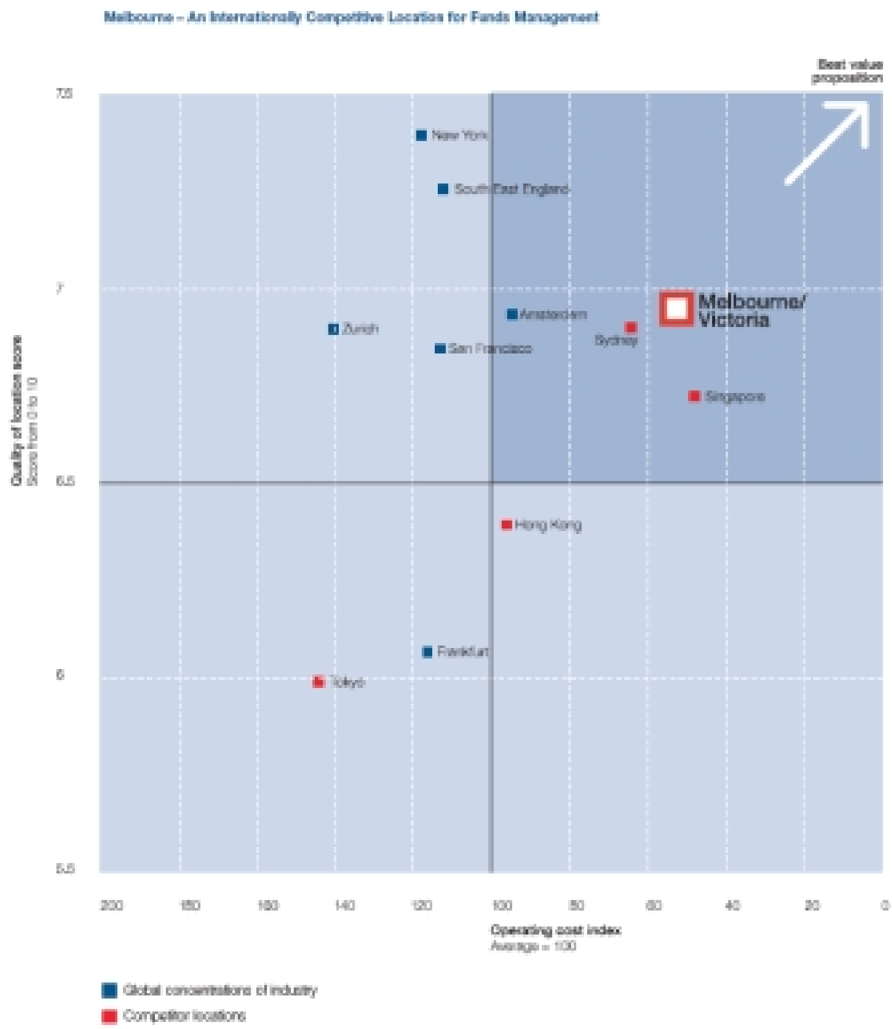
Table Four: Mercer Cost of Living Survey 2004 Top Cities

Rank	City	2004 Index
1	Tokyo, Japan	130.7
2	London, U.K.	119
3	Moscow, Russia	117.4
4	Osaka, Japan	116.1
5	Hong Kong	109.5
6	Geneva, Switzerland	106.2
7	Seoul, South Korea	104.1
8	Copenhagen, Denmark	102.2
9	Zurich, Switzerland	101.6
10	St. Petersburg, Russia	101.4
11	Beijing, China	101.1
12	New York City, U.S.A.	100
13	Milan, Italy	98.7
14	Dublin, Ireland	96.9
15	Oslo, Norway	96.2
16	Shanghai, China	95.3
17	Paris, France	94.8
18	Istanbul, Turkey	93.5
19	Vienna, Austria	92.5
20	Sydney, Australia	91.8

Source: Mercer, cited in Deloittes, 2004.

Melbourne has lower costs again.

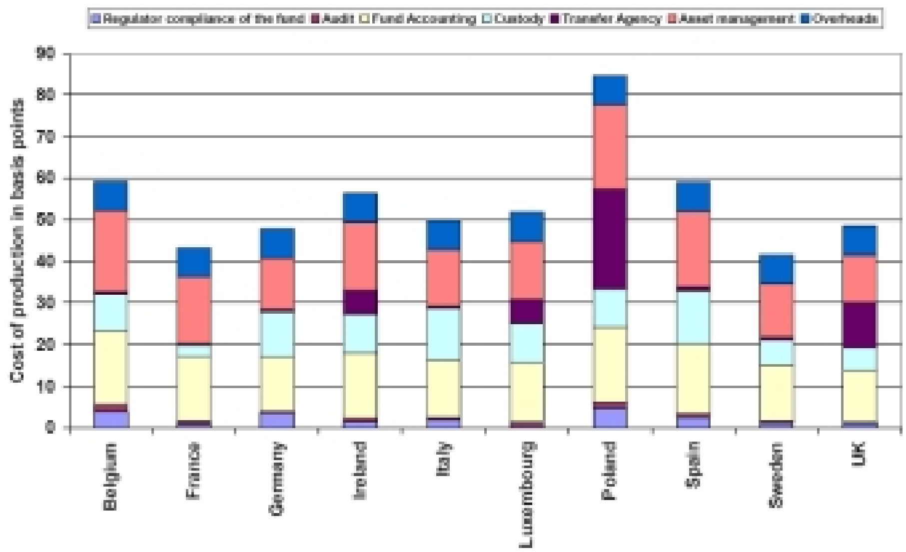
Figure Four: The competitiveness of Melbourne as a financial centre



Victorian Government, 2004, p. 13.

If we look a little further we will see also that the costs of production in Ireland and Luxembourg are not particularly low by comparison with other European centres which purchase their financial services.

Figure Five: Comparison of total production costs for equity funds by member state based on current average fund sizes



Source: CRA, 2006, p. 8.

The following things stand out from the chart. Firstly, although global financial centres are not among the highest-cost suppliers, nor are they among the lowest. Luxembourg, Ireland and the UK sit between 47 and 57 basis points, compared with outliers as low as 42 (Sweden) and 84 (Poland). Secondly it is notable that regulatory compliance costs are low in the financial exporters.[10]

But a third point is perhaps more important still. Even if regulatory compliance costs were as high as the worst case, Poland, the total cost of regulatory compliance would be five basis points. Now naturally, funds managers are keen to reduce costs throughout the production chain, so they might well gaze enviously at such a saving. But it is unlikely to provide the explanation for the relative competitiveness of the major global financial centres.

But what if direct regulatory compliance costs are really the tip of the iceberg, the only economic aspect of the costs of regulation that is conceptually and practically easy to measure? As we argue here, apart from regulating to deliver the safeguards they are there to deliver, financial exporters want their regulators to facilitate their legitimate export activities with the maximum of flexibility and minimum of obstruction. The very low levels of cost involved in regulatory compliance are at least suggestive of such flexibility.

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[10] It is possible that regulatory compliance costs are as low as they are in France because of the preponderance of bond trusts in France.

8. *'Law as a product' and regulatory dovetailing*

The complexity of regulation as experienced by the regulated entity will often extend well beyond the particular regulation in question. It can extend not only to other regulation imposed by the same government, but also to regulation imposed by other governments – or by non-government agencies with regulatory influence like standards boards. In this case the efficacy and functionality of any regulation cannot be judged on its own but only in relation to other regulation.

The multiplicity of sources of regulation and the efficiency with which they interface with each other has been one theme of discussion regarding roles and responsibilities under Australia's federation. Conflicting regulatory and tax demands from different levels of government within the federation has been of some significance in financial services – for instance in the case of taxes on financial transactions such as share purchases and banking deposits or withdrawals, though these issues have diminished in significance since the states rationalised some of their financial taxation.

Of much greater import for a global financial centre however, is the way in which its own tax and regulatory structure interfaces with the international jig-saw of regulation and taxation within which all international financial services firms find themselves. The complexities are immense.

To provide competitive after tax returns funds must take into account tax and regulation in the countries that are host to their investors, the countries that host the assets in which the fund invests and in the country in which the fund is domiciled.

Funds are often domiciled in tax havens to address these complexities (and simply to avoid tax). But this often triggers anti-avoidance measures in countries that host investors and/or high levels of withholding tax from countries that host the investments. Thus for instance a European investor seeking exposure to American assets may not be advantaged by investing in a (zero taxed) Cayman Islands trust holding such assets. Though avoiding Cayman Islands taxation, the investments in the trust will generally attract taxes (such as income withholding taxes) from the United States.

Thus a critical aspect of financial regulation in a global financial centre is optimising investors' taxation and investment options – considering the jigsaw of arrangements they face in their own country, in the country hosting the investments they have, and the country in which their fund is domiciled. As Deirdre Power of Deloitte (2005) puts it:

> Multinationals have been lobbying for many years for investment fund structures that allow assets to be pooled in an efficient manner. The holy grail is to have a fully tax-efficient structure that is totally tax neutral with no drag on performance. Essentially, the structure and its investors must

be exempt from tax in the location in which the fund is domiciled for tax purposes. In addition, a pooling fund vehicle should be considered tax transparent by the tax authorities of the investor location, investment location and fund location.

Note that, although financial centres do sometimes assist investors to avoid tax, the search for tax-transparent arrangements described above is better described as a search for a rational way through the maze of inter-country tax arrangements in an attempt to ensure that the global pooling of assets and globalisation of the funds management supply chain does not entangle the investor in multiple layers of taxation.

It is fairly obvious that in a context like this, how the existing tax and regulatory structure interfaces with the corresponding tax and regulatory structures of other countries is a highly complex optimisation problem which does not call for the kind of minimalism suggested by 'minimum effective regulation'. A more promising way to think of the challenges posed by financial exports is the co-evolution of business and regulation as a complex adaptive system. (Beinhocker, 2006)

9. *The co-evolution of business and regulation in global financial centres: a case study*

Certain hummingbirds have long curved beaks that give them an evolutionary advantage in supping nectar from orchards with long curved apertures. But which evolved first – the long beaks or the long apertured orchids? In fact neither could have evolved on its own. They co-evolved, each making the other's evolutionary pathway possible. [11]

To some extent this phenomenon of co-evolution can be seen going on in global financial centres as financial firms locate within a business and regulatory ecology that is congenial to them and then provide rich feedback to their host regulators on how to make the centre more congenial still. Generally both the firms and the regulators have a common interest in capturing more of the global financial market. Locally domiciled firms then acquire first mover advantages in operating within the new regulatory structures, and in influencing their further development and evolution.

Regulatory and tax innovations are often at the heart of the establishment of financial centres in the first place – as in the case of Ireland and Luxembourg – or of an existing financial centre receiving a new lease of life – as in the case of London's 'big bang'. This process of innovation typically continues as the incumbent firms within the centre provide feedback to the regulator and the

[11] When he visited Madagascar Charles Darwin predicted that a moth of particular dimensions existed based on the size and shape of a flower he saw there. It was discovered 40 years later.

regulator identifies with its firms' aspirations to capture more global market share.[12]

The response of Ireland and Luxembourg to the 'joint optimisation' problem of dovetailing its own financial tax and regulation with the tax and regulatory regimes of other countries provides an excellent case study in regulatory responsiveness or the co-evolution of financial centres and financial regulation. Regarding the examples discussed in the boxes below, in each case regulators are seeking what Deidre Power referred to as the 'holy grail' in global asset management – to give locally domiciled firms access to the greatest degree of transparency regarding tax levied in other countries.

[12] The comparison with Delaware remains pertinent. "In the competition for corporate charters among U.S. states, the leading incorporation state, Delaware, engages in significant and continual legal innovation". Romano, "Law as a Product," 240. in Romano, 2002, p. 199.

Box 4. A special vehicle for private family wealth management in Luxembourg

On November 20 2006 new legislation defining the characteristics and conditions of the *Société de Gestion de Patrimoine Familial* (or SPF) was laid before the Luxembourg Parliament. It was introduced just four months and one day after the European Commission declared that an earlier vehicle (the Luxembourg 1929 Holding Companies regime) violates the EC Treaty state aid rules (Article 87).

The new legislation rescues the essence of the earlier structure as a passive vehicle for the management of wealth by requiring that the new vehicles only be used to acquire, hold manage and dispose of financial assets but prohibiting their use to engage in commercial activity.

SPFs are exempt from Luxembourg's corporate income tax, municipal business tax and net-worth tax and from Luxembourg withholding tax on distributions. Though the vehicle is exempt from tax at the level of the entity, income is fully taxed once it is distributed to the private investor if the investor is resident in Luxembourg and is not taxed in Luxembourg if it is held by a non-resident.

In a way that illustrates how the authorities provide regulation as a service to the firms domiciled there Luxembourg charges a subscription tax at a rate of 0.25% applicable on its share capital, subject to a minimum of €100 and a maximum of €125,000 a year.

Source, Samantha Nonnenkam, 2006-7, Atoz, Luxembourg.

The story of Ireland's development of Common Contractual Funds (CCFs) is an ever clearer example of the regulatory ecology developed within an aggressive global financial centre in which regulators search with financial service providers for mutually beneficial regulatory structures. Having done much to attract global financial firms to Ireland, the Irish Government responded quickly to compete with a legal structure available in Luxembourg which was designed specifically to facilitate tax transparent pooling of funds.

Box 5. Northern Trust describes its joint search for a 'tax transparent' entity for asset pooling

In 2001, two multinational companies approached Northern Trust to participate in a consortium to identify a practical solution for cross-border pension pooling. . . . The group identified two major barriers: unfavourable withholding tax regimes threatened to create significant tax drag, negating the benefits, and in some countries local pension investment restrictions prohibited participation. The consortium examined multiple vehicles, investor countries and investment countries with a view to finding a vehicle that would accommodate multi-manager funds and multiple investment mandates. Moreover, the solution needed to be tax-neutral, i.e. the plans investing through the pooled vehicle should pay the same tax rate they would when investing directly.

In 2002, Northern Trust implemented cross-border pension pooling for two multinational clients, using Irish Unit Trusts. While the initial focus was global bonds, the vehicles now support fourteen different investment mandates, including fixed income, equities and fund of hedge funds. Pension plans from fourteen different countries participate, including plans in Europe, North America, Asia and Africa. Each subsidiary retains control over asset allocation, deciding whether or not to participate in the mandates offered. In practice, the pooling vehicles support global investment mandates of interest to the majority of subsidiary pension plans, while each plan's domestic investment mandates usually remain outside the pool.

The chief drivers have been enhanced governance and risk management. The company can leverage the firm's pension and investment expertise across a large pool of assets, implement a consistent investment strategy across all country plans, and establish greater consistency in investment manager selection and monitoring. The benefits to the subsidiary pension plans, particularly the smaller ones, can be considerable. They can achieve manager diversification and gain access to specialised investment mandates. At the same time, economies of scale in investment management, administration, custody, and audit translate to lower fees. The corporation as a whole benefits from more efficient administration through the elimination of multiple manager selection and monitoring processes across the globe and consistent, enhanced reporting from a single global custodian.

The Irish Unit Trust (IUT), however, does not offer an effective solution for all asset classes. Since US equities normally constitute about 50% of a global equity mandate, an investor (such as a Dutch or UK pension plan) who is exempt from withholding tax on US dividends will resist subscribing to a global equity IUT that must pay withholding tax on US equities. The resulting tax drag would overwhelm any cost benefits to be derived from pooling. To find a solution for US and global equity mandates, the consortium needed to identify a vehicle that tax authorities around the globe would recognise as 'tax transparent', i.e. the tax authority would 'look through' the vehicle and apply the tax rate as if the investors were investing directly into the market. A Belgian pension plan could pay a different tax rate than a UK pension plan, depending on the tax treaties between the investor country and the investment country.

Luxembourg and Ireland emerged as attractive domiciles for cross-border pooling. Recognised as the most highly regulated of the offshore markets, these domiciles minimise taxes on investment vehicles. Moreover, pension funds from around the world commonly invest in Irish- and Luxembourg-domiciled funds. Initial research suggested that the legal structure of the Luxembourg FCP (*Fonds Commun de Placement*) fulfilled the requirements for tax transparency. Ireland, however, lacked a similar vehicle. The Irish government acted quickly to fill the void. Eager to position Ireland to compete for multinational assets, in May 2003 the Irish government established a new vehicle, the CCF (Common Contractual Fund), specifically to support cross-border pension pooling. Similar in legal structure to the FCP, the CCF had one major competitive advantage.

The Luxembourg FCP was subject to a 1bp [One basis point] annual subscription tax, the Taxe d'Abonnement. When Northern Trust, acting in partnership with a multinational client, alerted the Luxembourg authorities to this issue, the government moved to eliminate the tax in the case of multinationals that use the FCP as a cross-border pension pooling vehicle.

Having established that both the CCF and the FCP could work, Northern Trust undertook the lengthy process of turning theory into practice. Tax authorities in a number of countries were asked to review draft management regulations and confirm the tax transparency of both vehicles. With close cooperation from two clients and assistance from Deloitte and Touche, Northern Trust began the detailed tax work required to support cross-border pooling for global equity mandates in both Ireland and Luxembourg.

At the same time, Northern Trust enhanced its operating platform to support tax-transparent vehicles. In order to support tax withholding and regulatory and tax reporting, the system needs to track income, capital gains and withholding tax at the investor level. At the most detailed level, the system must be able to track each investor's share of each holding (for example, attributing 2532 shares of XYZ stock to Investor A and 1488 shares of XYZ stock to Investor B.) Investors reap an added benefit. This solution can provide full asset detail and risk and performance reporting at the investor level, services not normally available with other pooled funds.

Years of focused effort are about to bear fruit. Two Northern Trust multinational clients are preparing to launch tax-transparent, cross-border pension pooling vehicles in 2005, one in Ireland and one in Luxembourg. The initial launch will focus on various global equity mandates, with a view to adding other asset classes at a later date.

Kathy Dugan, 2005.

10. The industry's assessment – 'even the hint of sticky fingers…'

We are now ready to propose an explanation for why the Australian funds management industry has not responded more vigorously to the reforms made at their request since 2000 (as enumerated above). Some in the industry concede that the buoyancy of the local market, driven by compulsory superannuation, has encouraged many firms to focus on servicing domestic needs – rather than exploring export possibilities.

Yet we have also spoken to several companies that consider themselves well placed to export financial services but which are hastening slowly. These firms are often subsidiaries of foreign firms, with a substantial and highly capable 'footprint' in Australia from which is managed smaller offices in Asia. These firms would like to build further capacity in Australia to export funds management into Asia. Yet there remains a sense of unease that Australia's financial exports may still not be 'safe' from regulatory and tax imposts. As one CEO put it to us "we have advice that certain tax provisions *shouldn't* hit the holdings of foreign investors in our funds, but we can't build our business around that. We need to know that they *won't*."

The CEO of another foreign owned fund manager that manages most of its Asian offices from its Australian headquarters puts a similar point this way.

> We don't mind paying Australian tax. We don't want tax breaks on our profits in Australia. We'll pay the going corporate rate. What we can't live with is the Australian government taking a cut of our investors' money on the way through to them. Foreigners won't invest with us and we can't build serious capacity to export funds management from Australia if there's even a hint of sticky fingers. If we can't get that certainty, we'll just do it from Dublin.

11. From domestic capability to export orientation

Compulsory superannuation has seen Australians become either the heaviest, or among the heaviest *per capita* investors in managed funds in the world, depending on the sources used (See Earlier Report). Returning to the analogy we drew earlier with export orientation in manufactures, we should note that what characterised success in the transition from inward to outward orientation was not the orderliness of the policy transition, but the energy with which it was pursued.

As economists tried to compare the evidence of development success with their theories, they found that many of the most successful exporting countries did not embrace liberal trading policies. Jagdish Bhagwati offered this suggestion for understanding the difference between failure and success:

> Instead of the chaotic selectivity of the incentive policies for 'import substitution' which seems to be the main focus of our trade-theoretic analysis, a more *important* inhibition on growth may in practice be the speed with which import substituting industrialisation is geared toward 'export promotion'. . . . [T]he key to success is not the absence of detailed, selective and target-oriented export promotion . . . . The distinguishing feature of superior export performance seems to be the pursuit of 'indiscriminate' and 'chaotic' but *energetic* policies to promote exports from industries which have been nurtured under protection in the first place (emphasis in original).[13]

Of course we are not advocating chaotic policies. But energy nevertheless counts for a lot. And in all matters trade-offs have to be made. The fact that Australia's financial services sector remains so lacking in export focus, given its apparent competitiveness on capability, skill and cost, suggests that greater vigour is needed to allow the industry to reach its considerable potential.

12. Next steps

This section sketches out some ideas for policy progress suggested by our analysis in this chapter.

At the outset it is worth mentioning that we are not in the position of a financial entrepôt that has constrained its own energies in pursuing tax avoidance wherever it threatens its financial exports. We begin from a point at which our financial services industry is heavily inwardly oriented, and so is in a weak position to insist that its own requirements for international tax transparency from Australia should take precedence over other policy goals.

For that reason we may need to target our actions more carefully – to ensure that exporters are free to thrive whilst minimising the extent to which special arrangements for them constrain our own abilities to meet other policy objectives – such as preventing tax avoidance.

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[13] Similarly, here is Anne Krueger describing the Koreans' "pragmatic" approach:

> [W]hen export performance was deemed satisfactory, policies were left unaltered; when however it appeared that export growth was faltering, changes were instituted until satisfactory performance was again observed. . . . The means chosen [to encourage exports] varied pragmatically in accordance with the degree of success then being achieved. . . . As those urged to export protested at various disabilities or disadvantages, means were found for removing such disadvantages; when exports lagged, new incentives were introduced or the value of existing incentives increased in order to spur export performance (1979: 85, 92-4).

Greater use of specialist vehicles

We have a penchant for simplicity in policy – once captured in Paul Keating's memorable description of his department's preference for 'long clean lines of policy'. Other things being equal, of course simplicity, consistency and neutrality between different corporate forms is desirable. It simplifies policy making and reduces distortions.

But things are far from equal. Lateral Economics has argued in another context (Lateral Economics, 2006) that the desire to unify the top marginal rate of taxation with the corporate rate is one example where long clean lines of policy will generate far more costs than benefits – by tying progress that is urgently needed (reducing the rate of corporate taxation) to progress that is less urgent (reducing the top marginal rate of personal taxation).

The demand for consistency across a wide range of circumstances can weigh down the speed and decisiveness with which we deal with legal and regulatory challenges as they arise. Our approach to corporate vehicles such as companies and trusts tends to value consistency of approach between the large and the small, between the foreign and domestically owned, between those focused on the domestic market and those who are exporting. And this consistency may be weighing us down in targeting solutions to specific problems.

For this reason we should give renewed attention to the scope to deliver better tax transparency institutions for financial services exporters by distinguishing between large corporate entities and smaller ones controlled by a small number of people. Where there was a concern that a new privileged class of corporate entity might create opportunities for avoidance, access to such an entity might be mediated administratively rather than legislatively. That is, businesses could have access to the regime only if, in the opinion of an administrator, they were a *bona fide* funds manager of a given size with an established reputation in the industry.

If we sought to establish entities that were particularly useful for exporters we could also limit them to funds that had, or undertook to achieve, some minimum level of export orientation – say 20% – and/or export growth over time. We should also consider giving such funds guarantees that foreigners investing in them would be exempt from any and all Australian capital gains and/or dividend withholding tax by virtue only of the fund being domiciled in Australia (though the manager of the fund would continue to pay tax on the profits they earned).

Lessons from Offshore Banking Units (OBUs)

In this regard it is important to take into account experience with earlier efforts to promote financial services exports in the past, particularly Offshore Banking Units (OBUs). Though many firms have taken advantage of the OBU structure and its tax concessions appear substantial on paper, they have not led to a strong expansion of financial services exports. The industry reports that this is because they cannot be accessed unless export activity is effectively quarantined from services supplied to the domestic market.

One can understand the logic of this from the perspective of the authorities. Yet at least until such time as we become a major exporter of financial services, the major gains from export are likely to come from *pooling funds and infrastructure between the domestic and export markets*. It is for this reason that we suggested above that if we sought to target some regime for financial services exporters, we should limit it to those with some minimum level of export orientation, rather than quarantining exported financial services altogether.

An agency to accelerate change

Although there has been a great deal of activity in removing impediments to exports in the last six years – activity that is ongoing – the impression still remains that regulatory change can be slow compared with the financial services entrepôts. We should investigate the case for establishing a well resourced agency which is able to accelerate the speed with which tax and regulatory matters concerning exports can be deliberated upon, if necessary with private rulings. AXISS has already built up substantial expertise in the area of promoting Australia as a financial centre and could perhaps be expanded to become a policy advocate within the Australian bureaucracy for measures to facilitate financial services exports.

Choice of special regimes

Once we are satisfied that we have identified a set of financial service providers who are *bona fide* exporters, we should consider widening the choice of regimes they can use. In addition to providing 'law as a product' – that is collaborating with them to arrive at arrangements which facilitate their export of financial services – we could even 'free ride' on the efforts of others. Thus we could announce that Australia would recognise the Irish Common Contractual Fund (CCF) regime (or consider recognising any other regime proposed by an export oriented financial centre) for use with Australian funds that were identified/designated as export-oriented funds. We could legislate to ensure that Australian courts recognised the regime (and possibly any precedents generated in Irish courts). We could also retain the right to modify some rule or precedent if we felt that it did not suit our purposes.

Lateral Economics has also drawn attention to the limited benefits that dividend imputation offers foreigners (2006). We should explore the scope to make our tax regime friendlier to increased investment by foreign companies – the kind of companies that would be instrumental in making Australia a global financial centre. At some cost to revenue we could give *bona fide* exporters of financial services (and at a greater cost to revenue we could give all firms) the choice between the existing corporate rate with dividend imputation or a lower rate – say 25 per cent.

An export culture in government and industry

Several industry leaders have expressed the view that to get good access to Asian markets we must achieve higher recognition in those markets. And particularly in Asia that means achieving higher profile representation. Accordingly it is important for ministers of high ranking – sometimes the Treasurer – to actively promote Australian financial service exports in Asia. Consideration should be given to the appointment of a minister assisting the Treasurer with special responsibility for supervising the tax and regulatory arrangements for financial services exporters and for promoting Australia's financial services providers in offshore markets.

Given its size and potential, financial services should be accorded a higher priority in trade negotiations – particularly with Asian countries to which we might become a substantial exporter of funds management and funds management expertise (in the establishment of Asian countries domestic financial services industries).

13. Conclusion: What is at stake

To summarise the 'in principle' case we have made so far, it is surprising how little we export financial services. We are world leaders in the management of pensions and sophisticated fund managers. New trends such as the move toward hedge funds have not taken long to take root in the Australian industry.

The sophistication of our financial sector rivals any in the Pacific region, at a time of continuing high growth and growing prosperity in Asia. China and India look bent on adding their combined population of over two billion more people to the list of prosperous people on earth – all closer to our time zone than the financial centres of Europe and the US. In these circumstances the prospects for Australia's financial sector to export its services should be bright indeed. So far as a country we have performed badly in this regard.

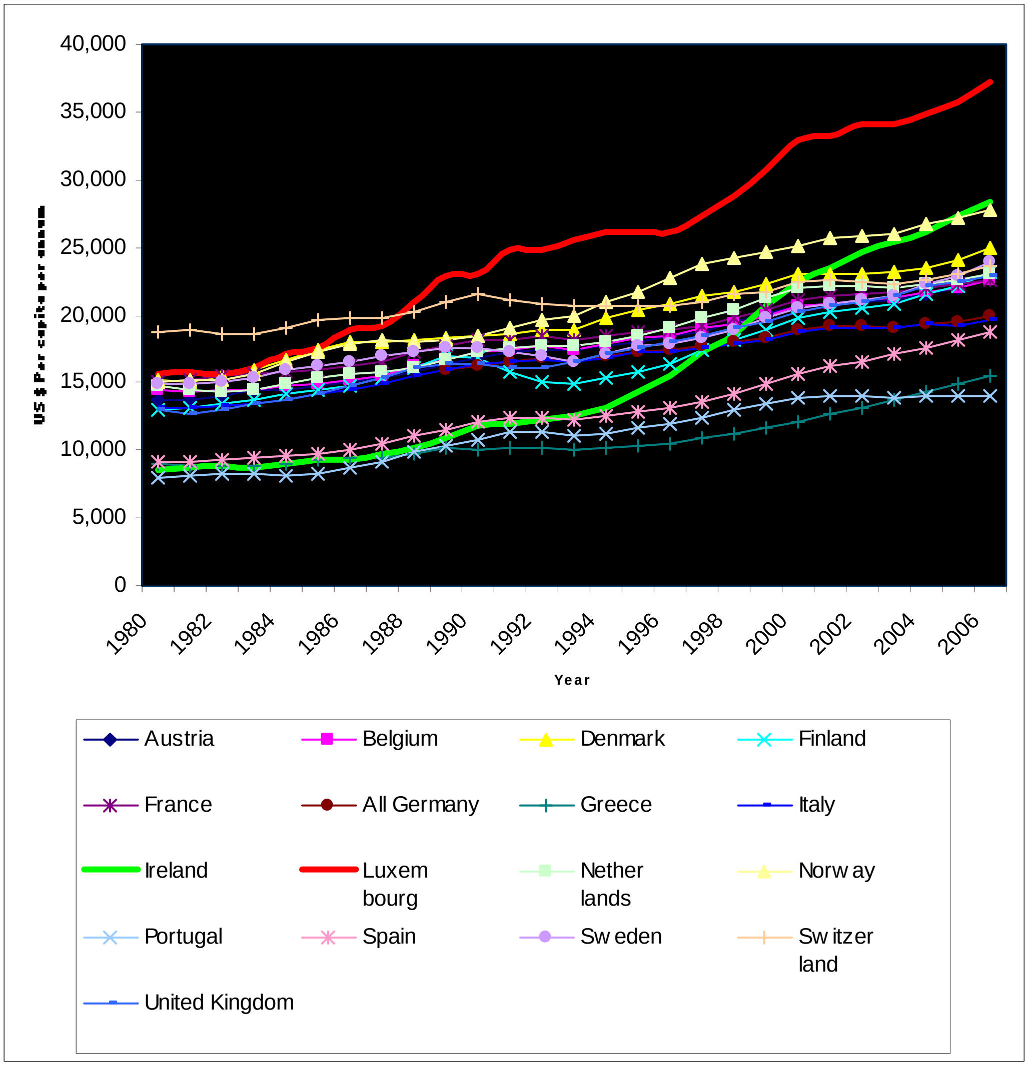
Where we are competing against city states in the region that have already made the transition from manufacturing to services entrepôts, the tax structure that we had five years ago may be a sufficient explanation for our poor performance. Indeed, if one were planning to locate substantial capacity to manage global funds on behalf of foreign investors in Australia, there remains the substantial risk of 'sticky fingers' – that is, of taxation being taken not just from the profits of the fund manager and the pockets of its employees (as one would expect) but from the portfolios of foreign investors. Given the presence of vigorous competitors seeking to attract global fund managers, it is fairly clear to see why they would succeed at our expense.

We appear to be turning that culture around. Further study is necessary for us to be completely confident of this finding. It certainly seems plausible that Australia could become very successful in competing for global funds management of foreigners' money if investors felt as secure from Australian tax and regulatory obstacles to efficient management having their funds managed from Australia as they do having their funds managed from a competing financial entrepôts.

While we will not in the short term become the Dublin or Luxembourg of the Pacific, the prize for doing so over time is substantial. Some of the worlds' richest cities are financial entrepôts, and no financial centre is anything but wealthy. This is not surprising when one considers the remarkable fact that in Australia average incomes in the finance sector – including those employed part time - are nearly twice the average paid in other industries.

However successful we are, our own financial exports will never become as large a share of our economy as they are in Dublin and Luxembourg. But then just some of their prosperity could make a large contribution. The following chart shows them both as the stand out economic performers of Europe. Over the last twenty years they are the only countries to clearly outperform Australia's per capita growth within the OECD.

Figure Six: Per captia income per year in selected European countries.



Source: Groningen Growth and Development Centre at www.ggdc.net.

As the graph illustrates, both economies 'took off' as they became financial entrepôts. Ireland's success is built on more than its financial sector. It has been successful in attracting other industries which have grown quickly. It has also pursued successful education policies and received unusually high subsidies from the EC for a time. But their success in the financial sector is a huge part of Luxembourg's success, and no small part of Ireland's. Financial services comprises around a third of Luxembourg's GDP and over ten per cent of Ireland's.

Given current salaries, if we were able to lift the proportion of the economy accounted for by financial services from its current 7.8% of GDP to Ireland's level of 10% then at current rates of salary, average wages would rise by over $600 per year.

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