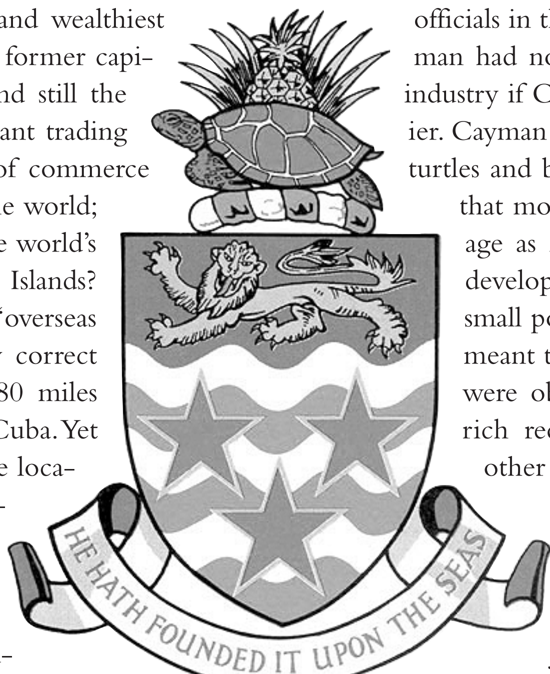
Offshore Prosperity

BY ANDREW MORRISS

Quick—without reading the next paragraph of this article, name the five largest financial centers in the world.

Answers: London, Tokyo, New York, Hong Kong, and the Cayman Islands. New York is the financial capital of one of the largest and wealthiest nations in the world; London, the former capital of a globe-spanning empire and still the capital of one of the most important trading nations; Hong Kong, the center of commerce for one of the largest markets in the world; and Tokyo, the capital of one of the world's wealthiest nations. The Cayman Islands? They are 100 square miles of an "overseas territory" (the modern, politically correct term for a colony) of Britain, 480 miles from Miami and 150 miles from Cuba. Yet those 100 square miles are now the location of billions of dollars of transactions and bank deposits.



The Cayman Islands Coat of Arms

Even more strikingly, 40 years ago Hong Kong, London, New York, and Tokyo were major financial centers and the Cayman Islands' major industries were exporting their men to work as sailors on merchant ships and making palm thatch ropes for sale to Jamaican fishermen. The three islands (Grand Cayman, Little Cayman, and Cayman Brac) were infested with mosquitoes and flies so fierce that inhabitants ran from their homes to their cars to escape the insects, and cows suffocated on the clouds of insects they inhaled. Today the islands are a tropical paradise, virtually free of biting insects, with more than a million tourists visiting annually and the islands *importing* labor (almost half the islands' population are foreigners). What happened?

A key reason for Cayman's success as an offshore financial center is that the islands proved a hospitable jurisdiction for policy "entrepreneurship." Several officials in the early 1950s recognized that Cayman had no choice but to develop a financial industry if Caymanians were to become wealthier. Cayman has no natural resources other than turtles and beaches. So little of its area is arable that most statistical reports list the percentage as zero. This ruled out the traditional development projects in agriculture. The small population and lack of a local market meant that industrial development schemes were obviously hopeless. Making Cayman rich required finding a way to convince other people to bring money to the islands and buy services.

These enterprising officials set out to create a legal and business climate that could compete with jurisdictions such as the United States for investors. They studied other jurisdictions' laws and selected the provisions they thought most likely to appeal to investors. They examined the islands' infrastructure and built what was needed to service a financial industry. For example, in the early 1960s communications from Cayman to other countries were handled by a single wireless station,

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operated by a man with a drinking problem. As one Cayman lawyer from that era told me, messages were fine if sent before lunch; after noon the content would be hopelessly garbled. To solve the problem, the government built an international telephone system to ensure that businesses would have reliable communications.

This entrepreneurial attitude continues. Today Cayman is the home of more hedge funds than any other offshore jurisdiction and second only to Bermuda in "captive" insurance operations (insurance companies owned by their insureds). More than 500 banks, including most of the leading banks in the world, have operations in Cayman. These successes resulted from Cayman's adoption of statutes that provided the legal environment necessary to lure such businesses to Cayman.

If you've heard of the Cayman Islands, chances are you've heard that they do not have an income tax. Not only is there no income tax, there is no direct taxation of any kind: no sales tax, no real-estate taxes, no value-added tax, nothing. What Cayman has is a series of fees for "service" (for example, for a banking license) and a 20 percent-plus duty on almost everything imported into the island. (The major exceptions to the high tariff schedules are luxury goods; luxury goods help the tourist industry and lower tariffs on them boost economic activity by allowing Cayman to offer attractive prices on goods from Rolexes to perfume.) Because virtually everything is imported, except for some fish and turtle meat, this is effectively a consumption tax rather than a trade-distorting selective tariff.

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The absence of direct taxation is important for two reasons. First, it encourages foreigners to invest capital in Cayman. Income earned by a Cayman trust or business remains tax-free until it is paid to someone in a country (such as the United States) that taxes income earned worldwide. Investors thus need not worry about losing their assets to Cayman. To ensure that investors have confidence that it will not renege on this bargain and impose a tax later, business entities, when created, are routinely granted 20-year renewable tax exemptions from the nonexistent taxes. As a result, if the Cayman government attempted to impose a tax in the future, investors would have plenty of time to move their capital elsewhere.

Even more important, the absence of direct taxation means that the Cayman government simply does not collect the sort of information routinely gathered by most countries' governments. Want to know how much a Cayman business earns? You can't find out by asking the government, since it never asks the business. If other governments want information, the Cayman government can't tell them since it doesn't collect the information in the first place.

The Cayman government's unwillingness to pry into Cayman companies' (and individuals') private affairs is paralleled by the strong protection provided by Cayman's Confidential Relationships (Preservation) Law 1995. Building on a foundation provided by the English common law, Cayman criminalized the breach of privacy by anyone with access to confidential information. Moreover, Cayman protects confidential information by requiring those seeking it to provide assurances that they can pay the costs of collecting the information and any harm that results from the disclosure.

Rule of Law

A critical part of Cayman's success, and one reason it is more successful than some other offshore financial centers, is that investors have confidence in the legal system. Putting money in a foreign jurisdiction is risky—if a new government takes power, it can easily renege on prior government commitments. Since governments generally have a poor record in keeping their promises, this political risk is a serious problem for small jurisdictions seeking to lure investors.

Caymanians understand this and have taken several steps to guarantee to investors that the legal system is stable.

First, the final court of appeal is not a Caymanian court but the British Privy Council. By effectively "outsourcing" this critical judicial function to an entity trusted by outsiders and incapable of being pressured by Cayman politics, Cayman has shown investors that it can be trusted not to violate its legal obligations.

Second, Cayman brings in outsiders to handle sensitive cases, importing jurists from other Commonwealth jurisdictions for specific trials and even to serve on the islands' appellate court. This helps assure investors that local prejudices will not sway the court, much as "diversity" jurisdiction in the U.S. legal system moves cases between residents of different states (over a financial threshold) to federal court to avoid the appearance of a "home court" advantage for the in-state litigant.

Third, the Cayman constitution (embodied in a British Parliament-passed statute) limits the scope for local political pressure to result in changes adverse to outside capital. There is no chief minister in the Cayman government; cabinet meetings are chaired by the British-appointed governor (who is never a Caymanian); and three "official" members of the legislature are appointed by Britain rather than elected.

Fourth, Cayman has repeatedly rejected independence, preserving these crucial links to Britain. When the United Nations Special Committee on Decolonization visited Cayman in 1977, for example, Caymanians firmly rejected its efforts to push them toward independence. As Sir Vassel Johnson, former financial secretary, put it in his memoirs: "They were told by the people of the three islands in a loud clear voice, 'Leave us alone.'"

Fifth, the key Cayman regulatory body for the financial sector, the Cayman Islands Monetary Authority (CIMA), is an independent agency rather than a politically controlled one. CIMA oversees banks and other offshore financial entities. The potential for rent-seeking in such an agency is huge—the chance to get even just a small slice of foreign investors' money has tempted many a nation's political class to take regulatory steps inconsistent with economic liberty. To prevent such behavior, Cayman gave CIMA extensive autonomy from local politics. For example, four of the nine directors on its board are non-Caymanians (currently two Americans, a Canadian, and a Englishman). Independent agencies and central banks per se raise their own problems, of course, but the point here is that Caymanians recognized that the need to provide security to investors required depoliticizing the regulatory framework and so raising the cost of political expropriation of outsiders' assets.

Finally, Cayman's budget depends heavily on financial-industry fees. Given the mobility of capital, this vulnerability helps ensure that Cayman will not renege on its commitments. Indeed, Cayman's success was partially made possible by the Bahamas' post-independence attempt to benefit Bahamians at the expense of its offshore financial sector. In the 1960s the Bahamas was the leading offshore jurisdiction in the Caribbean. But when the newly independent Bahamian government refused in the 1970s to renew work permits for non-Bahamians in the financial industry, in order to shift lucrative jobs to Bahamians, capital fled to the Cayman Islands.

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By guaranteeing its end of the bargain with foreign investors, Cayman has purchased prosperity at the price of some of its sovereignty. The price paid is remarkably low, however. Anytime Cayman wants full sovereignty, there is every indication that Britain would willingly cede it. The one thing Cayman can't do is get its sovereignty back fast enough to seize all the money and value in Cayman companies, banks, insurance companies, trusts, mutual funds, and hedge funds. By the time the British government had the paperwork done, investors would have had their accounts in a new jurisdiction if they wish. That gives investors the comfort to invest in Cayman.

Indeed, for many Caymanians, the highest cost of remaining associated with Britain comes from its imposing its own social-policy preferences on Cayman. For example, Britain unilaterally legalized homosexual sex in 2001 and abolished the death penalty in 1991. Both actions were unpopular in Cayman, a socially conservative and deeply religious society. Even more unpopular was Britain's action through an "Order in Council" that overrode local legislation.

Pressures to Change

Offshore jurisdictions face a variety of pressures to change their laws to eliminate their competitive advantages. Not surprisingly, for example, the countries that "lose" tax revenue to Cayman and other offshore jurisdictions aren't happy about it. The Organization for Economic Cooperation and Development (OECD; the cartel of wealthy developed countries) dislikes the whole idea of tax competition, the "harmful" lowering of tax rates to lure business. Fortunately, the Bush administration has shown less interest in helping the other high-tax OECD countries in their quest to reduce tax competition than the Clinton administration did, but the problem lurks in the background.

The offshore financial industry also faces threats from crime. The term "offshore" often calls to mind unsavory deals of the type John Grisham wrote about in *The Firm*. And some offshore jurisdictions have fallen victim to corruption and crime. For example, historian Jan Rogozinski called Aruba "the world's first independent mafia state," and most of Montserrat's banking industry was closed down after a financial scandal involving money laundering.

Resisting illegal activity is essential for successful offshore jurisdictions for at least two reasons. Most important, illegal transactions often bring with them corruption that is destructive of the level of trust necessary for a civil society to function. More pragmatically, illegal activity threatens the toleration of offshore jurisdictions by "onshore" jurisdictions such as the United States and the European Union. The physical and legal independence of jurisdictions such as Cayman, Bermuda, or the Channel Islands is precarious. It would take little effort for Britain to simply override Caymanian laws by altering the constitution or, in a more extreme case, for a company of U.S. Marines to overrun the island.

Less extreme onshore legal changes could cripple important aspects of the offshore financial industry. Of course, offshore jurisdictions are useful to European and American investors, which provides a degree of political protection against such threats. If, however, offshore centers become identified with al Qaeda financing, they are extremely vulnerable to onshore nations' pressure. Keeping their businesses in the legitimate financial sectors helps offshore financial centers protect their independence.

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Cayman has struck a balance between cooperating enough with onshore jurisdictions to preserve their toleration of offshore activity and maintaining its competitive advantage. Three steps help Cayman succeed in doing so. First, it insists on the principle of dual criminality in all cooperative efforts. That is, it will help other jurisdictions obtain information about funds in Cayman only if the activities being investigated are illegal there also. The result: cooperation on terror financing but not on tax investigations.

Second, Cayman assists foreign governments only in response to requests for specific information; it will not participate in "fishing expeditions" into a suspect's funds or activities.

Third, Cayman has expanded the areas in which it offers a competitive advantage well beyond tax levels. Caymanian accounting rules and insurance laws, for example, are far more favorable to the operation of captive insurance companies (through which firms can self-insure against some risks) than either U.S. accounting rules or most U.S. states' laws.

Not Quite Perfect

But wait—isn't this the Cayman *government* that is doing these things? Doesn't that compromise the integrity of the system? We should be skeptical of the classical-liberal pedigree of offshore jurisdictions for precisely this reason. Cayman may be freer than most places with respect to financial matters, but it is still not a libertarian haven, and so there had to be a flaw.

And it definitely is not a libertarian haven. A socially conservative society, Cayman has plenty of laws that many libertarians would object to: drug prohibitions, bar closing rules (midnight on Saturdays) built around religious observance, and the like. Cayman has also made many of its investments in infrastructure through government entities. The government built the airport, runs a national airline that frequently loses money, created the law school, set up the telecommunications network, and has undertaken a host of other activities that most libertarians and classical liberals would reject as outside the acceptable range of government activities.

Despite all these flaws, Cayman plays an important role in limiting government elsewhere. What Cayman provides is competition that keeps larger states more honest. All aspects of Cayman's legal system need not meet the ideal for it to play this role. Cayman's tax and regulatory rules force governments elsewhere to restrain their resource grabs. By providing an alternative, Cayman forces a sorely needed measure of discipline on the United States, European Union, Japan, and other "developed" countries not just with respect to taxes but also to a host of regulatory measures.

Moreover, because Caymanian society is small, the government is a lot less like the grasping Leviathan of larger states. Indeed, the society seems to have reached a consensus on the value of the offshore financial industry that is making the population among the wealthiest in the Caribbean, and that consensus is reflected in the tenor of the politics. Parties have not yet taken root in Cayman, and competition for office seems more based on personalities and competency than partisan divisions. The Cayman government has certainly made missteps from a libertarian perspective. Nonetheless, they have been less destructive of liberty, particularly economic liberty, than those of many of its larger neighbors.

Cayman's success is due to thinking differently about government. Cayman has gotten rich by realizing that the fundamental problem of government is to find institutions that convince people that the government won't take their money. In part, it is because it is small that Cayman is able to make credible commitments in the ways I have described. But it is also due to the creative design of its institutions that Cayman has succeeded. For example, in 1776 separating from Britain was a means of limiting government rent-seeking; today remaining connected to Britain offers Cayman an equivalent set of limits.

Can Cayman serve as a model for other governments? Many of the specific solutions chosen by Caymanians are unlikely to function if scaled up to a country the size of the United States. It could, however, prove an important model for local governments seeking to reassure investors that they will not find a new set of rules in place the day after their investment becomes final.

The entrepreneurial attitude that made Cayman the fifth largest financial center less than 40 years after the biggest local industry was thatch-rope manufacturing could be translated even to larger-scale governments. If people can learn to stop viewing governments as the source of subsidies and recognize the connection between institutions that protect property rights and wealth, other entrepreneurs may discover institutions that effectively limit even the most rapacious Leviathan.

Read More

Literature on Cayman history is hard to come by, and most Caribbean histories give Cayman little attention. The story of it offshore industry is told in Sir Vassel Johnson's somewhat uneven autobiography, *As I See It* (Book Guild Ltd., 2001). Michael Craton's *Founded Upon the Seas* (Ian Randle, 2004) is an excellent general history of the islands and includes some material on the financial industry. If you visit Grand Cayman, the government archive (near the airport) has a fascinating collection of oral histories; unfortunately none are available on the web. The Cayman Islands also feature in a sadder story involving classical-liberal principles, the destruction of a highly successful private conservation effort to save the endangered Atlantic green sea turtle by U.S. environmental legislation. This is described in Peggy Fosdick, *Last Chance Lost* (I.S. Naylor, 1994).