

The Economic Growth Effect of Offshore Banking in Host Territories: Evidence from the Caribbean

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Summary. — Following the success of renowned Caribbean offshore centers, several small islands have enacted offshore banking policies as a strategy for increasing economic growth. Several empirical studies have assessed the growth effect of such policies, but none accounts for sector size when estimating its growth impact. This study contributes to this literature by estimating the magnitude of offshore activity in each territory, and using this estimate as a continuous variable in an economic growth model. The results provide support for the hypothesis that facilitating offshore banking stimulates economic growth in host islands, and that the benefit is proportional to sector size.

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Key words — banking, caribbean, economic growth, financial intermediaries, offshore financial centers, tax havens

1. INTRODUCTION

The Bahamas, Cayman Islands, and the Netherland Antilles alone account for approximately two trillion dollars in international bank claims. The territories' longstanding history of low tax rates, coupled with the investor confidence and political stability gained through their dependencies with the United Kingdom and the Netherlands, facilitated this significant level of offshore banking activity (Palan, 2006).

More recently, many small island territories are implementing policies to develop an offshore commercial sector, one comprised of firms that conduct business only with non-residents, as a strategy to foster economic growth. The policy goal of this strategy is to attract foreign companies for the creation of employment, government revenue, and national wealth. Subsequently, the facilitation of offshore commercial activity has resulted in the licensing of over 100,000 international business companies in the offshore sector of host Caribbean islands. Despite the prevalence of this policy and its observed usage by international businesses, little economic research has been conducted to evaluate its impact on economic growth in host territories.

This paper reports the results of an econometric evaluation of the growth impacts of hosting an offshore banking sector in Caribbean nations and territories. Banking positions associated with the sampled countries are used as a measure of the offshore sector in each country. Specifically, the size of the offshore sector in each country is estimated by identifying the portion of external positions not attributable to the size of the domestic economy. An empirical growth model is then estimated in which the growth rate of real *per capita* GDP in each country is modeled as a function of the size of the offshore sector, and a number of other control variables. The results provide support for the hypothesis that the offshore sector has a positive causal effect on national income growth. In general, these results highlight the need for future research

that takes a detailed approach to evaluating the benefits and possible costs of facilitating offshore businesses.

The paper proceeds as follows. Section 2 provides an overview of offshore commerce in the Caribbean region. Section 3 reviews the literature related to the benefit and criticisms of offshore commercial industries. Sections 4 and 5 describe the econometric methodology and data. Section 6 presents the results and Section 7 concludes the study.

2. THE OFFSHORE BUSINESS SECTOR IN THE CARIBBEAN

Various definitions have been provided for offshore activities.¹ The term offshore financial center (OFC) will be used to describe a country or territory that provides special legislative incentives to attract and retain firms conducting financial business with non-residents. This study further defines OFCs empirically as those jurisdictions with a financial sector substantially larger than that needed for domestic economic activity.²

The attractions of these offshore centers include the low or nonexistent taxes levied on the financial institutions and businesses operating in the offshore sector (Desai, Foley, & Hines, 2006), which increases net earnings. Since OFCs afford an opportunity for tax avoidance, they are often considered to be tax havens. Hines (2005) uses the terms OFC and tax haven synonymously. Palan, Murphy, and Chavagneux (2010)

* The authors acknowledge numerous helpful comments and suggestions from three anonymous referees. The authors also thank the staff at the Bank of International Settlements for the timely provision of data and response to inquiries. The research in this paper extends Gordon's doctoral dissertation research conducted at the University of Delaware. Final revision accepted: September 20, 2012.

discuss the distinctions between OFCs and tax havens while recognizing that most OFCs afford tax advantages. For the fifteen Caribbean nations and territories included in this study, all nine identified as OFCs are also considered to be tax havens, as are Grenada and St. Lucia, which have not yet developed a sizable offshore financial center.³

Caribbean nations have been sequentially adopting policies to develop offshore financial and business sectors. The earliest observance of an offshore business sector is in the Netherlands Antilles, a territory that has characteristically facilitated international business activity. The territories of the Bahamas, Bermuda, and the Cayman Islands, have a longstanding history of low or zero taxes,⁴ while a number of other Caribbean islands have enacted offshore policies in recent years. Further, most Caribbean OFCs are sovereign states but have political ties to industrialized countries such as France, Netherlands, and the UK. Table 1 lists the islands that have enacted offshore business and banking legislation by the date of enactment.

Caribbean offshore centers vary in both the size and the composition of the offshore sector. The size of the offshore sector ranges from the large, longstanding offshore centers of the Bahamas and the Cayman Islands to Grenada, which enacted offshore banking legislation but as yet has no registered offshore banks. Table 2 provides information on the size and composition of the offshore sector in each country for which data are available.

Offshore sector policy is directed to harness various areas of specialization across Caribbean OFCs. Some of these include international banking, insurance, asset management, mutual funds, and structured finance (Lane & Milesi-ferretti, 2010). The Cayman Islands have the largest offshore banking sector in the region, where the asset value of offshore banks in 2005 was estimated at US\$900 billion. It also has significant offshore activity in other financial services such as insurance and investment fund management. Offshore insurance companies in the Cayman Islands were estimated to have an asset value of US\$19 billion. In addition, there are more offshore investment funds listed in the Cayman Islands than any other OFC.⁵

The commercial activity in other leading offshore centers is concentrated in insurance provision or other forms of international business. For example, even though Bermuda has no purely offshore bank, it has the largest offshore insurance activity in the region, with a reported asset value of US\$21 bil-

lion in 2008. Further, it has a significant offshore stock listing with market capitalization estimated at US\$350 billion.

Barbados also has a significant amount of offshore insurance business. In 2009 Barbados reported 441 registered insurance companies with an estimated asset value of \$13 billion dollars. Likewise, a significant offshore sector is observable in the Turks and Caicos, the Netherlands Antilles, and St. Kitts, as there are a large number of international business companies registered in each territory.

Offshore business companies locate in the Caribbean to minimize costs. It is often the case that offshore businesses have minimal, if any, real physical presence. In addition a special characteristic of the sector in these countries is the lack of competition with local sectors. Offshore banks and international business companies are prohibited from conducting business with residents. They operate solely to supply goods and services to non-residents. Regardless, many small island nations view offshore centers as an opportunity to increase domestic commerce, facilitate capital inflow, and create wealth. This study undertakes an evaluation of whether offshore financial sectors contribute to wealth creation in these countries.

3. LITERATURE REVIEW

A crucial question for economic policy is whether policy affects the steady state rate of growth, and if so, which policies increase growth the most? In this regard, do offshore sectors affect steady state growth in host countries? The realized benefit of housing an offshore sector logically depends on whether resident offshore companies locate operations in the host country or are purely brass plate licensees (Hampton, 1994). The economic benefit of a sector with predominantly brass plate companies may only include the government revenue earned from any licensing fees rendered. An offshore sector with a physical presence creates additional benefits from the employment and operational expenditures they generate.

Continued growth of the offshore sector enhances national benefits. Of course, growth of the sector is dependent on the demand for offshore services, the regulatory benefits, and the cost and any other advantages it provides. The demand for offshore activities, including banking services, is largely determined by the demand in large developed nations (Hampton,

Table 1. *Year of offshore sector enactment*

Country	Statute	Year
Netherlands Antilles	Commercial Code of the Netherlands Antilles	–
The Bahamas	Banks and Trust Companies Regulation Act	1965
Bermuda	Tax Exemption Act	1966
The Cayman Islands	Banks and Trust Companies Law	1966
Barbados	Offshore Bank Act	1979
Turks and Caicos	Companies Ordinance	1981
Antigua	International Business Companies Act	1982
The British Virgin Islands	International Business Companies Act	1984
Montserrat	International Business Ordinance	1985
Aruba	Exempt Company Act	1988
Anguilla	International Business Companies Ordinance	1994
Dominica	Offshore Banking Act	1996
St. Vincent	International Bank Act	1996
St. Kitts and Nevis	The Financial Services Statutory Rules and Order	1997
St. Lucia	International Bank Act	1999
Grenada	International Companies Act	2002
Jamaica	International Financial Services Act	2011

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