Why worry? The impact of the OECD harmful tax competition initiative on Caribbean offshore financial centres

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Why Worry? The Impact of the OECD Harmful Tax Competition Initiative on Caribbean Offshore Financial Centres

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ABSTRACT The economies of small states are vulnerable to a variety of external factors—economic, political and environmental. One economic/financial factor confronting those small states with offshore financial centres has been the effort by the OECD to eliminate tax arbitrage (harmful tax competition). A related initiative to eliminate money laundering and combat the financing of terrorism has increased the regulatory responsibilities and costs to these small jurisdictions and represents an example for the potential consequences of the OECD project. Using economic data from several Caribbean jurisdictions, this article investigates the direct impact of these international programmes to increase financial regulation upon their financial services industries. Two specific outcomes are demonstrated: a reduction in employment opportunities and a decline in government revenues. At present this situation bodes ill for the continued operation of offshore financial centres as a method towards achieving economic development.

KEY WORDS: Small states, offshore finance, harmful tax competition, money laundering, OECD, FATF

Introduction
This article presents one very discrete example of economic vulnerability in support of the more extensive research on small state vulnerability. The main purpose is to demonstrate that small jurisdictions with an offshore financial centre (OFC) had a valid concern about the impact of international efforts to constrain their freedom of action to establish and maintain an OFC.¹ A paper prepared by the Commonwealth Secretariat for use at the September 2000 meeting of Commonwealth Finance Ministers described the potential impact on such states as one in which “output and employment could fall sharply,” with possible spill-over effects for the rest of their economies (Commonwealth Secretariat, 2000, p. 10). There are two main problems for small states that emerge from the Organisation for Economic Co-operation and Development (OECD) project against tax competition: first, the potential decline of
employment within the territory and, second, the potential reduction in non-tax
government revenues. The concern here is foremost the OECD project to
eliminate harmful tax competition among states, but other regulatory measures
promoted by the Financial Action Task Force (FATF) and the European Union are
also in play.

The economic rationale for a project to eliminate international tax competition is
very simple: tax competition is “harmful” because it distorts “patterns of trade and
investment” reducing global welfare (Wilson, 1999). In broad terms the OECD
constructed a view of global welfare as the aggregate of local welfare provision and
living standards. Consequently those investors utilising tax havens to reduce their
domestic tax obligations fail to contribute to the public welfare of their state of
residence—“national defence, education, social security, and other public services”
(OECD, 1998, p. 14). This specific OECD project has also been promoted as a
means to fight other forms of financial crime, such as money laundering and the
financing of terrorism (Witherell, 2002). The justification for the project, and the
arguments made against it, will not be addressed within the confines of this article.
Rather, a brief sketch of the OECD project and these two problems open the next
section, before outlining the offshore banking situation within four of the 16
Caribbean jurisdictions with offshore financial centres. This selection includes one
state with a relatively large offshore sector, the Bahamas, and two states with
comparably small sectors, Dominica and St Vincent and the Grenadines. The fourth
jurisdiction discussed is one of the nine non-self-governing territories located in the
Caribbean, the Cayman Islands. The concluding section offers a preliminary
evaluation of the influence of the OECD campaign on employment and state revenue
in the offshore Caribbean up to the end of 2003. This cut-off point represents yet
again the observation made by Oral H. Williams et al. (2005) of the challenge
confronting research on small states resulting from “data paucity and its
unavailability in the public domain” (p. 1174).

Caribbean Offshore Financial Centres

The existence of low-tax jurisdictions offering financial services to non-resident
individuals or firms has come to be viewed as a threat to the fiscal foundations of
developed states (Tanzi, 2002). The OECD project portrayed tax competition as a
global problem. It not only permits individual free riders (be they individuals or
firms) to benefit from a state’s public goods, but it also creates free riders within
international society. The OECD argues that states that foster competition for
mobile capital with their tax regimes thereby reduce the tax revenue collected by
home jurisdictions. “In a still broader sense, governments and residents of tax
havens can be ‘free riders’ of general public goods created by the non-haven
country” (OECD, 1998, p. 15). The OECD subscribes to an argument that mobile
capital travels through an OFC with the singular purpose of avoiding taxes
(Huizinga and Nicodème, 2004). An elegant description of this situation comes from
Zygmunt Bauman.

In its heavy stage, capital was as much fixed to the ground as were the labourers
it engaged. Nowadays capital travels light—with cabin baggage only, which
includes no more than a briefcase, a cellular telephone and a portable computer. It can stop-over almost anywhere, and nowhere needs to stay longer than the satisfaction lasts. (Bauman, 2000, p. 58)

This condition of mobility means that the oversight and control necessary for the collection of taxes is increasingly difficult (Vlcek, 2004). The OECD’s perceived loss of tax revenue is believed to be the small states’ gain, in the form of licence fees. Yet, as seen in the tables below, the quantities collected in fees are nowhere near the levels of tax losses claimed by some commentators. Furthermore, the ‘race to the bottom’ argument made about OECD tax rates has been challenged and declared to be more of a “race to the middle” (Hobson, 2003). The crucial point to recognize at this stage is that the creation of an offshore space emerges from the use of sovereignty to carve out a regulatory and legislative space with the specific intention of creating a space of reduced regulation in comparison with OECD states. While the offshore regime is a form of regulatory arbitrage, it also serves to strip away any previous ‘national identity’ attached to mobile capital (and to ships, websites, international business companies, etc.) (Palan, 2002).

Readers of this journal will already be familiar with what was perhaps the most strongly worded critique of the Harmful Tax Competition Initiative. Ronald Sanders offered “a Caribbean perspective” on the project in 2002, stating quite bluntly that the project was “an instance of fiscal colonialism” (Sanders, 2002, p. 326). This criticism is based in part on the fact that the establishment of an offshore financial services sector has been a very successful move for economic development by a number of small jurisdictions (Commonwealth Secretariat, 2000). In fact, one study found that, among the small jurisdictions analysed, the presence of a “well-developed financial services sector” was the single most important variable indicating economic success (Armstrong and Read, 1995). However, as a result of this OECD initiative jurisdictions with an OFC are now confronted by two major problems. The first involves a decline in the employment opportunities provided by the offshore business sector (Persaud, 2001, p. 209). The second problem is the loss of a government revenue source for the small state, a problem strikingly similar to the claim made to justify the OECD’s project—that harmful tax competition has reduced state revenue. It is important to recognize that the OECD’s harmful tax competition initiative is not the only international programme confronting offshore financial centres. The FATF was established in 1990 to provide “an inter-governmental body whose purpose is the development and promotion of policies to combat money laundering” (FATF, n.d., p. 1). Even though money laundering has been established as a distinct financial crime, it is often conflated with tax avoidance or evasion and the harmful tax competition project. The FATF identified a number of jurisdictions as uncooperative with anti-money laundering objectives in June 2000 as part of its effort to eradicate money laundering from banking and finance (both domestically and internationally). Included in this list from the Caribbean were Antigua and Barbuda, the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, Dominica, St Kitts and Nevis, St Lucia, and St Vincent and the Grenadines (FATF, 2000). The campaign to implement and enforce legal structures against money laundering and the financing of terrorism has increased the costs of maintaining an OFC and consequently also reduced the contribution made to
economic development (Sharman, 2005). The blacklist approach to disciplining recalcitrant jurisdictions was criticized, and in 2002 further additions to the FATF list ceased when evaluation responsibilities passed to the International Monetary Fund (IMF). The Forty Recommendations (plus Nine Special Recommendations on Terrorist Financing) of the FATF are now part of a wider World Bank/IMF programme to evaluate and assess national financial and banking sectors across a number of subject areas. Readers interested in these larger initiatives to promote global financial stability via global financial governance should consider Eatwell and Taylor (2000), Soederberg (2004) and Underhill and Zhang (2003). In the case of the Forty Recommendations (plus Nine), the issue remains problematic for small jurisdictions because, while the IMF may conduct oversight and evaluation, responsibility for their development remains within the limited membership of the FATF, as well as with its membership’s specific areas of concern, which may not be amenable to development (Sanders, 2005, p. 237; see also Tsingou, 2005). 9

The analysis presented in this article is focused upon four Caribbean jurisdictions. As noted in the opening paragraphs, the Bahamas represents a relatively large and mature offshore financial sector, having been in operation for decades. Contrasting with the Bahamas are Dominica and St Vincent, which have small offshore sectors created in the mid-1990s with the specific objective of diversifying the domestic economy in response to the decline in banana exports. The fourth jurisdiction that will be discussed is the exemplar for offshore finance, the Cayman Islands, which has a mature and deep offshore sector. The presentation of data on these four Caribbean jurisdictions extends the research presented in Williams et al. (2005).

The Bahamas

The Bahamas is a chain of islands lying close to Cuba and Florida, and it has been a significant global player in the offshore business sector for a number of years. 10 Its economy is heavily dependent on tourism (mostly from North America) and on this offshore business. During the period 1990–98 the Bahamian services sector absorbed 80% of the labour force, and in 2000 tourist receipts contributed 67% of total export earnings. Tourist receipts amounted to a total of US$1814 million in 2000, 38% of GDP ($4800 million) (Commonwealth Secretariat, 2003, pp. 111, 135). The global economic slowdown and decline in tourism after 2001 hit the Bahamian economy hard, and the offshore financial services sector also experienced a decline (Commonwealth Secretariat, 2003, p. 9). The economic impact on offshore services was in part a result of new legislation targeted at strengthening anti-money laundering enforcement in the Bahamas.

The action to strengthen the anti-money laundering laws was a necessary response to the FATF report in 2000, which found that “although the Bahamas has comprehensive anti-money laundering legislation, there are serious deficiencies in its system” (FATF, 2000, p. 2). The report further noted that new legislation was pending in the Bahamas to address the identified weak points. After the revised legislation was enacted, the Bahamas was removed from the list of non-cooperative jurisdictions in 2001. A further result of the new legislation was the closure of a number of institutions unable or unwilling to comply with some aspect of the enhanced regulatory regime.
The Central Bank of the Bahamas highlighted one change in the new licensing requirements in its quarterly report. There is now a requirement for financial institutions to maintain “an appropriate physical presence in the jurisdiction.” In March 2001 an analysis of the impact of the new regulation on offshore banking in the Bahamas predicted “that approximately 60 banks will not be able to comply with the new physical requirements and will wind-up their managed operations” (Central Bank of the Bahamas, 2001, p. 38). The analysis proved accurate, for the number of offshore banks and trusts licensed in the Bahamas declined from 395 in 1999 to 333 in 2001 and then down to 250 in 2003 (see Table 1). The decline in the number of institutions was accompanied by a decline in employment within the financial services sector. More recent analysis from the Central Bank remained optimistic about the long-term consequences of the changes in financial sector regulation. “Ongoing efforts to strengthen the supervisory framework should enhance The Bahamas’ reputation as a safe, well regulated jurisdiction” (Central Bank of the Bahamas, 2003a, p. 43). One reason for this continued optimism is clear, for even with “a significant reduction in the number of licensed banks and trust companies”, the financial services sector of the Bahamas was estimated to contribute between 15% and 20% of GDP in 2004, see revenue data in Table 2 (Central Bank of the Bahamas, 2003a, p. 34).

### Table 1. The Bahamas, offshore entities and employment

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Offshore banks and trusts (public and restricted)</td>
<td>398*</td>
<td>395</td>
<td>388</td>
<td>333</td>
<td>276</td>
<td>250</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bahamian employees</td>
<td>682</td>
<td>764</td>
<td>772</td>
<td>836</td>
<td>991</td>
<td>1 001†</td>
<td>987†</td>
<td>839†</td>
</tr>
<tr>
<td>Non-Bahamian employees</td>
<td>124</td>
<td>128</td>
<td>130</td>
<td>142</td>
<td>195</td>
<td>244†</td>
<td>239†</td>
<td>222†</td>
</tr>
<tr>
<td>Total employees</td>
<td>806</td>
<td>892</td>
<td>902</td>
<td>978</td>
<td>1 186</td>
<td>1 245†</td>
<td>1 226†</td>
<td>1 061†</td>
</tr>
<tr>
<td>Registered offshore entities</td>
<td>27 896</td>
<td>16 114</td>
<td>15 130*</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Notes:** *Estimated; †These values were annotated with a ‘p’, indicating that the data were provisional in the Quarterly Economic Review, March 2004.

**Source:** Central Bank of the Bahamas (2001; 2002; 2003a; 2004a).

### Table 2. The Bahamas, offshore licence revenue (Bahamian $000s)

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Business and professional licence fees</td>
<td>33 678</td>
<td>58 504</td>
<td>55 061</td>
<td>54 661</td>
<td>55 778</td>
<td>53 776</td>
</tr>
<tr>
<td>Includes company fees and registration</td>
<td>4 407</td>
<td>4 522</td>
<td>4 733</td>
<td>3 854</td>
<td>4 907</td>
<td>5 237</td>
</tr>
<tr>
<td>Includes international business companies</td>
<td>8 010</td>
<td>17 381</td>
<td>17 247</td>
<td>13 290</td>
<td>18 000</td>
<td>16 604</td>
</tr>
</tbody>
</table>

**Source:** Central Bank of the Bahamas (2003b; 2004b, Table 7.2). NB—all data values were annotated as provisional.
Dominica is a small island in the Lesser Antilles. Dominica, Grenada, St Lucia, and St Vincent and the Grenadines together comprise the Windward Islands. Agricultural land constitutes roughly 20% of the island’s 754 square kilometres of territory and is used primarily for bananas. In addition to the impact of hurricanes on the banana industry, banana exports are also being affected by changes to international banana trade agreements over the past decade (Lewis, 2000). A lack of beaches on the island’s rugged coastline and the absence of an international airport hamper Dominica’s ability to diversify into the tourist sector. Consequently Dominica has turned to offshore financial services as a diversification strategy (Feracho and Samuel, 1997, p. 250).

In August 2004 Dominica reported that its offshore sector comprised one offshore bank, four internet gaming companies and some 1200 international business companies (IBCs). The IMF report on Caribbean Offshore Financial Centers included data for Dominica’s offshore sector for 2001. In its report the IMF listed five offshore banks, six gaming companies and 7536 IBCs; in addition to these entities, the IMF listed two offshore insurance companies and five trust companies (Suss et al., 2002). As a contributor to Dominica’s GDP, the banks and insurance sector provided 10.4% in 1988, which had increased only to 13.2% by 2003. This economic sector has failed to offset the decline in the banana industry over the period 1988–2003. Agriculture provided 28.8% of GDP in 1988, but had dropped to 17.7% by 2003 (see Table 3).\(^\text{11}\)

The small offshore sector of Dominica was identified by the FATF as a non-cooperative jurisdiction in its first report in 2000 and removed from the list in October 2002. The 2003 report listed Dominica as “among the first to place its offshore banks under the direct supervision of the Eastern Caribbean Central Bank (ECCB), in conjunction with the local supervisory authorities” (FATF, 2003, p. 13). Other changes undertaken by Dominica were the establishment of a financial intelligence unit and new legislation strengthening anti-money laundering capabilities. By coordinating bank supervision with the ECCB Dominica was able to overcome the FATF concern that its OFC appeared to be “largely unregulated” (FATF, 2000, p. 5).

The circumstances of the collection of islands and cays known as St Vincent and the Grenadines are similar to Dominica. These islands are volcanic and mountainous and 30% of the land is used for agriculture (out of a total area of 389 square kilometres). Historically the most important crop has been bananas for export but, just as with Dominica, their contribution to the economy has declined. In 1988 agriculture provided 21.2% of GDP for St Vincent, but by 2003 agricultural products had dropped to just 11.2% of GDP. Concurrently the contribution of the banking and insurance sector provided 7.4% of GDP in 1988 and increased slightly to provide 9.48% in 2003 (see Table 4).

The International Financial Services Authority (IFSA) of St Vincent reported that the government made a policy decision in 1996 to set the offshore financial services sector at “the forefront of the national economy.” This policy required an extensive revision of existing legislation and the creation of additional legislation to define the limits and operation of their offshore financial services sector (IFSA, 2004). The
### Table 3. Dominica—GDP by economic activity at factor costs, constant prices (Eastern Caribbean $000 000s)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total GDP</th>
<th>Banks and insurance</th>
<th>Agriculture</th>
<th>Hotels &amp; restaurants</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>351.72</td>
<td>347.78</td>
<td>369.84</td>
<td>377.78</td>
</tr>
<tr>
<td>As % of total GDP</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>101.44</td>
<td>86.61</td>
<td>92.49</td>
<td>91.96</td>
</tr>
<tr>
<td>As % of total GDP</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>28.84</td>
<td>24.90</td>
<td>25.01</td>
<td>24.34</td>
</tr>
<tr>
<td></td>
<td>5.28</td>
<td>5.52</td>
<td>7.63</td>
<td>8.82</td>
</tr>
<tr>
<td>As % of total GDP</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1.50</td>
<td>1.59</td>
<td>2.06</td>
<td>2.33</td>
</tr>
</tbody>
</table>

**Note:** Hotels and restaurants provided as a proxy for the tourism business sector.

**Source:** Eastern Caribbean Central Bank Research Department (2004).
<table>
<thead>
<tr>
<th>Year</th>
<th>Total GDP (Eastern Caribbean $000 000s)</th>
<th>Banks and insurance</th>
<th>Agriculture</th>
<th>Hotels &amp; restaurants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total GDP</td>
<td>412.14</td>
<td>424.66</td>
<td>452.98</td>
<td>459.32</td>
</tr>
<tr>
<td>Banks and insurance</td>
<td>30.55</td>
<td>32.61</td>
<td>34.65</td>
<td>35.33</td>
</tr>
<tr>
<td>As % of total GDP</td>
<td>7.41</td>
<td>7.68</td>
<td>7.65</td>
<td>7.69</td>
</tr>
<tr>
<td>Agriculture</td>
<td>87.84</td>
<td>83.16</td>
<td>95.98</td>
<td>84.00</td>
</tr>
<tr>
<td>As % of total GDP</td>
<td>21.31</td>
<td>19.58</td>
<td>21.19</td>
<td>18.29</td>
</tr>
<tr>
<td>As % of total GDP</td>
<td>2.02</td>
<td>2.12</td>
<td>2.23</td>
<td>2.39</td>
</tr>
</tbody>
</table>

**Note:** Hotels and restaurants provided as a proxy for the tourism business sector.  
**Source:** Eastern Caribbean Central Bank Research Department (2004).
revisions failed to find approval with the FATF with respect to the deterrence of financial crime. As with Dominica, the FATF identified St Vincent’s small offshore financial sector as a non-cooperative jurisdiction in 2000. In particular, “it was the strict secrecy afforded by the Confidentiality Act [1996] that brought St Vincent and the Grenadines to the attention of the [FATF]” (Drayton, 2003, p. 170). The list of specific shortcomings included the absence of anti-money laundering regulations for the offshore sector and the limited resources that were allocated to supervising offshore financial institutions (FATF, 2000, p. 10). The government of St Vincent enacted a series of further legislative changes to respond to the assessment of the FATF. Again, as with Dominica, one change was the provision for joint supervision of offshore banks between the Eastern Caribbean Central Bank and the IFSA of St Vincent (Drayton, 2003, pp. 172 – 173; FATF, 2003, p. 6).

The size of the offshore finance sector within St Vincent and the Grenadines is also similar to that of Dominica. Data provided for August 2004 identified one offshore bank and 620 international business companies. There is a small number of international trusts, mutual funds and insurance firms, but no internet gaming companies. These figures represent a decline in the size of St Vincent’s offshore sector over the previous seven years. From the data provided by the IFSA the number of offshore banks peaked in 2000, when there were 13 in these islands. Similarly the high point for IBCs was in 1999, when they were reported to number 2704. This pattern holds for the other offshore entities based in St Vincent and the Grenadines. Even with some fluctuations between 1997 and 2004, in general there were fewer offshore entities in each category in 2004 than in previous years (see Table 5).

These three Caribbean jurisdictions provided commitment letters to the OECD indicating their intention to cooperate with the goals and objectives of the OECD project. From the perspective of the OECD the agreement of these sovereign states represented progress in meeting the original goals of the harmful tax competition initiative. However, these documents often contain what some commentators identify as the “Isle of Man Clause” (Van Fossen, 2003, p. 266). This declaration

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</thead>
<tbody>
<tr>
<td>International business companies</td>
<td>1188</td>
<td>1540</td>
<td>2704</td>
<td>2175</td>
<td>1438</td>
<td>858</td>
<td>742</td>
<td>620</td>
</tr>
<tr>
<td>International trusts</td>
<td>19</td>
<td>210</td>
<td>236</td>
<td>251</td>
<td>124</td>
<td>37</td>
<td>12</td>
<td>7</td>
</tr>
<tr>
<td>Offshore banks</td>
<td>2</td>
<td>10</td>
<td>11</td>
<td>13</td>
<td>6</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Mutual funds—public and private</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Fund manager/administrator</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>International insurance and insurance manager/broker</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>3</td>
<td>6</td>
</tr>
</tbody>
</table>

Note: *As categorized by the International Financial Services Authority of St Vincent and the Grenadines. Note also that these figures do not necessarily reflect the number of entities in good standing in that year.

serves to emphasize the expectations of these small jurisdictions to receive treatment equivalent to that afforded to OECD members (Woodward, 2004, p. 119). One result of this tactic has been the creation of a Sub-group on Level Playing Field Issues in order to determine exactly what constitutes a level playing field for global finance (Global Forum on Taxation, 2004).

**The Cayman Islands**

In general the trends within offshore finance that are found in the sovereign small states are present also in the small non-self-governing jurisdictions. Once again, the Cayman Islands are the exemplar for a small jurisdiction offshore financial sector to the extent that they are identified as the offshore location of choice in popular fiction and film. In 2003 the offshore sector in the Caymans included 322 banking trust firms (Category ‘B’ licences), 644 captive insurance firms, 4808 registered offshore mutual funds (also known as hedge funds), and 68 078 registered companies. As the business most directly affected by the OECD harmful tax competition project, the number of banking trust firms has declined from the number licensed in 1997 of 475 to 322 firms in 2003 (see Table 6). Similar to the offshore financial sector of other jurisdictions, the downward trend has been in the number of firms operating in the international banking sector. The Cayman Islands Monetary Authority (CIMA), however, did not specifically point at increased regulation concerning taxation and financial crime as the reason for the decline. Rather, the phrase most frequently used in their annual reports to explain the year-to-year fluctuation in the number of

<table>
<thead>
<tr>
<th>Table 6. Cayman Islands offshore entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking trust licences Category ‘A’*</td>
</tr>
<tr>
<td>Banking trust licences Category ‘B’**</td>
</tr>
<tr>
<td>Firms with a physical presence Class ‘B’ (captive) Insurance licences</td>
</tr>
<tr>
<td>Registered mutual funds (offshore hedge funds)</td>
</tr>
<tr>
<td>Trust service provider licences</td>
</tr>
<tr>
<td>Registered companies</td>
</tr>
</tbody>
</table>

*Notes: *A licence to provide services to domestic and international markets; **A licence to provide services to international markets, and to facilitate inter-bank transactions.

*Sources: *Cayman Islands Monetary Authority (1998–2003); Cayman Islands Economic Research Unit (2002; 2003).
licences was that the change resulted from “mergers and acquisitions in the global financial market” (CIMA, various).

The downward trend in licences issued to offshore banking institutions is not found in other segments of the Cayman Islands’ offshore business sector. Licences issued for captive insurance firms, offshore mutual funds and registered companies have all increased throughout the period 1996–2003. The number of captive insurance firms licensed in 1996 was 418 and increased to 644 in 2003. These firms reported total assets of US$19.2 billion in 2003, up from the $8.4 billion reported for 1997 (see Table 6). Likewise the number of registered mutual funds grew from 1335 in 1996 to 4808 in 2003, a figure noted by the Annual Economic Report in 2003 as representing more than half of all hedge funds globally (Economic Research Unit, 2003, p. 21). For the economy of the Cayman Islands, the fees collected on bank and trust licences, insurance licences, mutual fund administrators and company registrations generated between 18% and 28% of all government revenues in the period 2000–03. As a point of comparison, revenue collected from taxes on international trade generated between 34% and 39% during the same period (see Table 7).

**Table 7.** Cayman Islands offshore licence fee revenue (Cayman Island $000 000s)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking and trust licences</td>
<td>10.1</td>
<td>8.9</td>
<td>33.3</td>
<td>28.9</td>
</tr>
<tr>
<td>Insurance licences</td>
<td>2.9</td>
<td>2.9</td>
<td>5.5</td>
<td>n.a.</td>
</tr>
<tr>
<td>Mutual fund administrators</td>
<td>3.2</td>
<td>3.7</td>
<td>11.8</td>
<td>12.5</td>
</tr>
<tr>
<td>Company fees</td>
<td>35.0</td>
<td>37.3</td>
<td>38.6</td>
<td>39.9</td>
</tr>
<tr>
<td>Sum of fee revenue</td>
<td>51.2</td>
<td>52.8</td>
<td>89.6</td>
<td>81.3</td>
</tr>
<tr>
<td>Taxes on domestic goods and services</td>
<td>104.8</td>
<td>113.1</td>
<td>150.8</td>
<td>153.4</td>
</tr>
<tr>
<td>Taxes on international trade and transactions*</td>
<td>110.0</td>
<td>106.2</td>
<td>106.7</td>
<td>117.6</td>
</tr>
<tr>
<td>Total revenue**</td>
<td>278.2</td>
<td>285.4</td>
<td>314.1</td>
<td>326.2</td>
</tr>
<tr>
<td>Fee revenue as percentage of total revenue</td>
<td>18.4</td>
<td>18.5</td>
<td>28.5</td>
<td>24.9</td>
</tr>
<tr>
<td>International trade taxes as percentage of total revenue</td>
<td>39.5</td>
<td>37.2</td>
<td>34.0</td>
<td>36.1</td>
</tr>
<tr>
<td>GDP</td>
<td>1444.9</td>
<td>1482.3</td>
<td>1546.0</td>
<td>1603.2</td>
</tr>
<tr>
<td>Fee revenue as percentage of GDP</td>
<td>3.5</td>
<td>3.6</td>
<td>5.8</td>
<td>5.1</td>
</tr>
</tbody>
</table>

**Notes:** *This includes travel and cruise ship tax and the Environmental Protection Fee imposed on all visitors, as well as duties placed on imported goods; **This includes items not listed here, property taxes, sales tax, etc.; †Incomplete data.

**Source:** Cayman Islands Economic Research Unit (2002; 2003).

Conclusions

It is clear that there has been a decline in the number of offshore banks licensed in the Caribbean. While the FATF may be substantially responsible for this reduction, the implementation of an OECD-guided information exchange regime in the future could have a wider impact. Its regime could have similar results to those seen with the EU Savings Tax Directive, a movement of assets to those jurisdictions not currently participating in the OECD process (e.g. Singapore, where a shift related to the Directive was already anticipated in early 2004 (Rawlings, 2005)). This global
move away from the Caribbean would lead to further reductions as demand for services dropped, an effect not seen as a consequence of the anti-money laundering campaign with assets on deposit in the Bahamas for example (see Figure 1). The wider consequences could involve more than simply banks if, similar to the EU Savings Tax Directive, all ‘paying agents’ were obligated to report details (i.e. non-financial institutions and professions including mutual funds, hedge funds, trust companies and lawyers).

The individual Caribbean offshore financial sector may have experienced a decline in funds on deposit between 2000 and 2003, as seen for the Bahamas in Figure 1. Nevertheless, the assets reported on deposit in the Bahamas for 2003 still exceeded those reported for any of the years between 1994 and 1999. As discussed, the Bahamas underwent an extensive effort to comply with international anti-money laundering standards and now has fewer offshore banks. The decline seen in the size of foreign assets on deposit in the Bahamas in 2001 is more likely to be the result of the economic recession in the USA than of fewer banks.

I would characterize the specific case of the OECD’s harmful tax competition project and small Caribbean states (and contrary to their cooperation with the FATF’s anti-money laundering regime) as a ‘lose-lose’ situation. At present the flow of capital through these offshore financial centres continues to increase, while the implementation schedule for the information exchange regime desired by the OECD has been repeatedly postponed. Essentially this latter aspect of the situation represents a ‘lose’ for the OECD. The economic benefits that were provided by a successful offshore business sector have shrunk during the period explored here for

small Caribbean states. The level of employment and the revenue from licensing declined along with the number of registered bank and trust firms. This condition represents a ‘lose’ for the economic development of states with OFCs; truthfully, whether it is the result of the FATF, OECD or some other distributor of global governance is immaterial to the prospects of the continued use of offshore finance to provide a development opportunity. The experience of the Cayman Islands, on the other hand, suggests that it is beneficial for one’s offshore sector to be diversified. Within this particular jurisdiction revenues from licensing non-bank businesses continued to grow, even though the revenue from bank and trust licensing fees declined. But this does not guarantee continued success for the Cayman Islands, British Virgin Islands and other locations specializing in the registration of International Business Companies (IBCs). The OECD is engaged in a separate campaign to counter the use of “corporate vehicles for illicit purposes.” Given the use of corporate entities registered in the Cayman Islands in both the Enron and Parmalat corporate scandals, this will remain an item of concern (see OECD, 2001).

A more recent assessment of the Caribbean situation by Sanders (2005) is that in the end only the strong will survive, because they may be capable of absorbing the increased costs of complying with globally imposed regulation (p. 19). Jason Sharman (2005) has called this process the “scissors effect”, whereby small jurisdictions are trapped between the rising blade of compliance costs and the lowering blade of reduced licence revenue. Peter Clegg (2005) argued that the UK’s overseas territories are in a position similar to that of the Caribbean states even though somewhat sheltered by their relationship with this OECD member state. Therefore, in response to the question posed by the title to this article—yes, there is cause for concern. As demonstrated here, first the FATF blacklist and subsequent regulatory changes affected the number of licensed banks. The response to the EU Savings Tax Directive in some quarters further suggests that capital will relocate in the event of a more comprehensive taxpayer information-reporting regime such as desired by the OECD. At the same time delays to the OECD’s desired timeline for the implementation of its project represents some small measure of success for small states as a result of their resistance, even if it has been fundamentally through the power of rhetoric (Sharman, 2006). Finally, just because the Caribbean jurisdictions may exist on the periphery of the world system does not mean that they must accept some subordinate status to other, similarly sovereign, jurisdictions solely because of their size. Resistance opens up opportunities from ‘below’ beyond the limited chances offered by the alternatives presented from ‘above’ by the OECD.

Acknowledgements

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Notes

1. A brief note on terminology. Offshore financial centres are found within sovereign states and non-self-governing territories (such as the Cayman Islands, Jersey and Hong Kong). The term ‘jurisdiction’ is used when both territorial entities are the topic of discussion.

2. An offshore financial centre provides more than just banking services. In the Caribbean various jurisdictions also specialize in providing international business company registrations, insurance company registrations, shipping registrars, and mutual and hedge funds.

3. This determination of ‘global welfare’ is demonstrated by a singular example suggesting that “global welfare enhancing cross-border capital flows” was a process that had “improved welfare and living standards around the world by creating a more efficient allocation and utilisation of resources.” (OECD, 1998, p. 14)

4. In addition to the jurisdictions covered here, Williams et al. (2005) briefly discussed the offshore financial centres of Anguilla, Antigua and Barbuda, Barbados, the British Virgin Islands, Grenada, and St Kitts and Nevis.

5. The remaining jurisdictions are: the sovereign states of Antigua and Barbuda, Barbados, Grenada, St Kitts and Nevis, and St Lucia; the British non-self-governing territories of Anguilla, the British Virgin Islands, Montserrat, and the Turks and Caicos Islands; the Dutch non-self-governing territories of the Netherlands Antilles and Aruba; and the USA-associated Commonwealth of Puerto Rico. To this list of Caribbean offshore financial centres, the North Atlantic island of Bermuda is often added.

6. Space does not permit a full exploration of the tax competition literature, which goes back at least to Charles Tiebout’s (1956) article ‘A pure theory of local expenditures’. Let it simply be noted here that, while there is general agreement on the existence of tax competition, there is no agreement on whether it is in fact harmful, rather than beneficial. See Edwards and Keen (1996); Schulze and Ursprung (1999); and Wilson (1999).

7. For example, Oxfam argues that for developing states alone the lost taxes amounted to $50 billion annually (Oxfam, 2000). More recently the Tax Justice Network has estimated a tax loss of $255 billion from wealth deposited offshore (Tax Justice Network, 2005).

8. The other jurisdictions identified on this first ‘blacklist’ were Belize, the Cook Islands, Cyprus, Gibraltar, Guernsey, the Isle of Man, Jersey, Israel, Lebanon, Liechtenstein, Malta, the Marshall Islands, Mauritius, Monaco, Nauru, Niue, Panama, the Philippines, Russia and Samoa.

9. As of October 2005 the FATF blacklist had been reduced to Burma and Nigeria (FATF, 2005).

10. In 1983 Richard Johns identified five major offshore financial centres in the Caribbean basin—Bermuda, the Bahamas, the Cayman Islands, the Netherlands Antilles and Panama. (Johns, 1983, p. 191).


12. The Category ‘B’ Banking and Trust licence is issued specifically to firms providing services to international markets and performing inter-bank transactions.

References


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Central Bank of The Bahamas (2004b) Quarterly Statistical Digest, 13(3).


