



**CENTRAL BANK OF TRINIDAD
AND TOBAGO**



**CARIBBEAN CENTRE FOR
MONETARY STUDIES**

**XXVIIIth ANNUAL CONFERENCE
ON MONETARY STUDIES**

**GROWTH IN IBC'S IN THE BVI: IMPLICATIONS FOR FISCAL
AND BALANCE OF PAYMENTS PERFORMANCE**

Oral Williams

EASTERN CARIBBEAN CENTRAL BANK

October 28 - November 1, 1996
Conference Facilities - 16th Floor, Central Bank of Trinidad & Tobago

*IMPACT OF GROWTH
IN INTERNATIONAL BUSINESS COMPANIES
ON THE BRITISH VIRGIN ISLANDS ECONOMY:
LESSONS FOR THE ECCB AREA*

By

Reginald Darius
and
Oral Williams

Research and Information Department
Eastern Caribbean Central Bank

*Paper Presented At The
XXVIII Annual Conference on Regional Monetary Studies
Port of Spain, Trinidad*

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INTRODUCTION

Small island developing countries are perpetually struggling with the problem of generating the required levels of savings to generate investment and sustain an acceptable growth path. With domestic savings being inadequate, most countries attempt to supplement available resources with foreign savings in the form of foreign direct investment, multilateral and bilateral financial flows. To increase domestic savings great emphasis is placed on the containment of the current account deficit by promoting exports given the difficulties associated with controlling imports.¹ However, countries within the region have pursued both import substituting and export promoting strategies. Export of primary commodities which are sold on protected foreign markets, remain a major foreign exchange earner of a number of Caribbean islands. Naive attempts at import substituting industrialization were largely unsuccessful and in many cases exacerbated the very problems which they sought to solve (Girvan and Jefferson, 1984).²

The British Virgin Islands (BVI) is a third world country which departed from the primary product specialisation development strategy, as policy makers realised that with limited manpower and natural resource endowments, the road to prosperity had to be non-traditional.³ To achieve the goal of sustained growth the policy makers sought to develop the island as an Offshore Financial Centre (OFC) through legislation of the International Business Companies Act in 1984. Due to the attractive conditions which offered by the BVI and instability in other offshore centers

¹The ratio of imports to GDP is in the range of 60-70 per cent in the OECS (World Bank Report 1994, pg. 31). According to the report the current account deficit usually exceeds 20 per cent of GDP, thus indicating extreme dependence of these economies on external funds.

²See Girvan and Jefferson (1984), for further exposition of the problems encountered in implementing import substituting industrialization.

³ The BVI, is a group of 40 islands of which one third is uninhabited, the islands have a combined population of 16,108 individuals with a large immigrant component (see CDB country strategy for the BVI {1994}).

the territory has emerged as one of the leading OFCs in the world. In 1994, the BVI had a total of 136,112 International Business Companies (IBCs) registered, representing 47.7 per cent of the total global offshore company formation (Figure 1).⁴

The development strategy has proven to be successful and has made the BVI one of the most prosperous small island developing states in the World, attaining average growth rates of approximately 5.3 per cent over the past eight years. The contribution of the industry to the national economy has been phenomenal as 45 per cent of government revenue is derived from that sector and in 1993 the industry paid out in excess of US\$7.6m in wages and salaries.

The success of the BVI as an offshore jurisdiction was due to the favourable conditions which obtain internally and externally. The BVI has a very stable political climate with no history of social and political tensions. The country's legal and regulatory framework is amongst the most efficient in offshore jurisdictions thus ensuring that there are unnecessary constraints imposed on qualified applicants. The BVI has enhanced and continues to develop the requisite financial and legal infrastructure to ensure the provision of the necessary services, leading to the establishment of the foremost international service firms in the BVI.⁵ These firms are serviced by a well educated labour force of domestic and foreign origin. The BVI also has a well developed telecommunications service which was provided by Cable and Wireless. In addition, the island is very accessible by air and is strategically located relative to the major world trading centers in North America and Europe.

The offshore services initially provided by the BVI catered to the incorporation of IBCs. This deliberate policy was based on a strategy to market a niche product, which was differentiated from offshore banking in the Cayman and captive insurance in Bermuda.⁶ However, given the vulnerability of the industry and the increase in competition from other centres, there is an urgent

⁴ Offshore financial centers are places where expert financial and professional skills are available to residents whether corporate or personal in different jurisdictions.

⁵International firms represented in the BVI includes Trident Trust group, Citco group, Canada's Royal Trust Group and the British Accountants, Rawlinson and Hunter, (See Euromoney May 1989).

⁶See BVI Business age magazine pg. 117

need for policies to be instituted to develop the BVI as a fully fledged OFC. The policy makers are aware of this shortcoming and have already implemented some measures to eliminate this deficiency.

The main purpose of this paper is to assess the impact of growth in IBCs on the fiscal and growth performance of the BVI. The paper also seeks to illustrate that appropriate budgetary systems are essential in aiding the management of financial resources, avoidance of wastage and the averting of “Dutch Disease” effects. This is important as it has been observed that once there is an influx of foreign funds many developing countries have consistently exhibited an inherent inability to effectively manage these resources. The paper argues that given the vulnerability of the BVI economy to external shocks, there is need for the institution of a stabilisation fund or fiscal reserve fund to reduce the impact of fluctuations in offshore industry activity and external shocks on the fiscal performance of the country.

The paper is divided into three sections. Section one, reviews the incentive framework which has encouraged the development of the country as a leading offshore center. Section two examines the impact of IBCs on the economic and fiscal performance of the BVI, along with the macroeconomic management issues which arise. Issues related to a stabilisation fund and debt management are discussed. Section three examines the lessons and prospects for the Organisation of Eastern Caribbean States (OECS) territories in developing a similar strategy.

SECTION I

INCENTIVE STRUCTURE

Legal and Regulatory Framework

The critical legislation which is believed to have propelled the growth of the offshore IBC industry in the BVI is the International Business Companies Act of 1984. The establishment of the Act was in response to the US decision to terminate the double taxation treaty with the BVI. This treaty was the backbone of the BVI fledgling financial services sub-sector.⁷ The act is now recognised as a model for other countries seeking to encourage the development of OFCs. The 1984 Act made allowance for offshore investors to register their companies in the BVI and take advantage of the numerous incentives offered under the Act. The provisions of the Act includes exemptions for foreign companies from taxes on corporate earnings, dividends, or other distributions to shareholders, taxation on capital gains realised by the company, estate, inheritance or gift taxes. The act requires minimal reporting and disclosure, directors and shareholders names are not required, bearer shares may be issued, capital may be denominated in any currency and there are no exchange controls. Flexible management arrangements allow for one director, the holding of meetings by telex or telegrams and the possibility of an IBC in the BVI transferring its place of incorporation to another jurisdiction or to a non BVI company.

In recognition of the limitations of the reliance on a single service product and increased international competition, new provisions and amendments to existing policies are continuously being made. The move towards diversification has resulted in the enactment of new legislation which include the Insurance Act of 1994, that seeks to regulate that sector. It is designed to provide security for domestic policy holders, and at the same time attract offshore captives and

⁷Double taxation treaties are bilateral arrangements between two sovereign nations. Their principal traditional purposes have been to encourage private flows between countries by reducing tax induced barriers to such flows. Treaties mitigate double taxation of income by more clearly dividing the taxation jurisdiction between the two countries. The host country reduces or eliminates its claim to tax income arising within it, and, to the extent this elimination is incomplete, the country from which capital originates relieves any remaining double taxation by including a foreign tax or exemption from its own taxation. (See IMF(1993), Double Taxation Treaties Between Developed and Developing Countries).

reinsurance business.⁸ The Act exempts some applicants from a number of provisions and provides prospective clients with a high degree of confidentiality. In addition, the Act has been particularly effective in attracting business from certain niche markets such as medical insurance. In 1995, the Mutual Funds Act was passed which made provisions for the corporate use of mutual funds as investments and concurrently providing protection for investors.⁹

The offshore industry is highly susceptible to scandal and corruption; to guard against this, the BVI has developed a regulatory system which has thus far successfully protected the reputation of the BVI as an ethical jurisdiction. With the non-existence of a central bank, the financial sector is monitored by the Ministry of Finance.¹⁰ Supervisory and regulatory functions are performed by the Financial Services Inspectorate and the Inspector of Banks and Trust Companies. The BVI is also actively involved in International Banking and Insurance Regulatory Organizations, and has membership in the Caribbean Financial Action Task Force whose main role is to combat money laundering. The BVI also participates in a mutual legal assistance treaty with the United States which encourages exchange in information related to crimes, without any requirement for the sharing of tax related information. The government has enforced legislation which allows for the seizure of assets that cannot be legally accounted for under the Criminal Justice Act and the Drug Trafficking Offenses Act.

Despite the firm regulatory framework, the efficiency of the system allows for company incorporation within a maximum of two days. However, there are concerns about the capacity of the existing mechanism to adequately monitor the entire offshore sector given the establishment of offshore insurance companies with limited information available on their operations, the presence of absentee companies and the lack of supervision of IBCs holding banking licenses. The Association of Registered Agents (ARA), which includes all members of

⁸See insurance act 1990

⁹See mutual funds act 1992

¹⁰The financial sector comprises four Commercial Banks and four Offshore banks, a few foreign owned Insurance Companies a Social Security Scheme and one state owned Development Bank.

the BVI financial community, plays its part in the regulation of the system by the adaptation of a code of conduct and professional ethics as well as contributing to prospective legislation.

Stability

One of the factors that has contributed to the overwhelming success of the BVI as an offshore centre, is the stability conferred by its dependent territory status of the United Kingdom, which is responsible for the external and judicial affairs of the country. The BVI has adopted the British legal system which is traditionally probative and transparent. The existence of British oversight has enhanced the international credibility of the island. The use of the US dollar as a medium of exchange also engenders a measure of currency stability which is complemented by the absence of exchange controls. It is noteworthy however, that because of the effective management of the industry by Government of the British Virgin Islands (GOBVI) over the years, the United Kingdom adopts a watchful hands off role thus allowing for a high degree of internal flexibility.

Communications Infrastructure

One of the fundamental prerequisites for the development of a vibrant offshore center is the availability of a modern communications network. The BVI is equipped with sophisticated and reliable telecom services which are state of the art. Cognizant of the growth in IBC incorporation and the associated expansion in the demand for telecom services, Cable and Wireless commenced provision of a fully digital network system in 1987 with a greater capacity to accommodate this development. The services currently available include fibre optic technology, access to the global digital highway and systems design and consultancy. In a continued attempt to upgrade the services provided there are plans to provide a group 5 fax facility to accommodate easy transmission of multiple pages, voice and data lease lines and carob net packet switch, which facilitates the accessing of huge databases.

The BVI also possesses, reliable air access through its two airports and the availability of courier services which offer 'next-day' flights between the BVI and major business centres in the United States and Europe.

Education

The Offshore Financial service industry is a high skill industry, hence for a country to remain competitive it must have at its disposal a pool of domestic experts in areas such as banking, finance, insurance, accountancy, legal and company management. Cognizant of this fact, GOBVI has expended resources in the area of human resource development. Emphasis has been placed on the training of locals in financial service skills by conducting domestic training and providing funds for foreign study in the relevant fields. Reflective of the concerted efforts placed on educational development the BVI currently has a 98.7 per cent literacy rate. However, given the central position of education in this industry, there is room for improvement. A recent business survey by Deloitte & Touche International revealed that 76 per cent of respondents cited problems with suitable staff recruitment as a constraint to their business' growth potential, and 97 per cent wished to see improved education and training.

Information available on the offshore sector indicated that the industry employed over 300 individuals in 1993 with 74.1 per cent being BVI residents (Peat Marwick, 1993).¹¹ Of the locals employed within the industry 12.6 per cent were qualified. It is expected that given future plans for the industry over the next decade, there is likely to be an increase in demand for Trust officers, Business Majors, Accountants and Chartered and Executive secretaries. At the time of the Peat Marwick study there were 28 Accountants, 19 Trust officers and 39 corporate secretaries, employed within the sector. The majority of the remaining employees were clerks, bookkeepers, secretaries and typists.

¹¹Statistics provided on employment are taken from the 1993 offshore industry survey conducted by Peat Marwick

The policy makers have recognised that all the human resource needs of the industry cannot be satisfied domestically, hence the policy makers have adopted an extremely liberal approach to the issuance of work permits. This policy allows firms to acquire foreign experts to service the industry with minimum difficulty. In 1993, 25.9 per cent of the employee's within that sector were foreigners of which 75 per cent were qualified. Given that the service industry employs over 80 per cent of the workforce the authorities have now incorporated the role of services in economic development in its secondary education curriculum. The education sector accounts for between 16 and 20 per cent of budgeted expenditures. In keeping with the emphasis on adult education, a tertiary education facility was constructed in 1993.

External Environment

The internal policies are not totally responsible for the success of the sector as the domestic policies have been complemented by a favourable external environment. The demand for offshore centers has grown quite rapidly over the years in line with increases in personal and corporate wealth and the revolutionary advances being made in technology and communications. Growth in the offshore sector was also facilitated by the continuous expansion of multinational companies which cater to shareholders and not the country of origin. These companies are constantly seeking favourable environments to conduct business, given the proliferation of taxes and regulation in developed countries. The booming offshore sector in the BVI, has benefited greatly from uncertainty within competing locations; for example many Hong Kong firms have established offshore operations in the BVI, since Britain agreed in 1984 to surrender the country to China. The political crisis in Panama resulted in a substantial transfer of business to the BVI, and increased fee's in the Isle of Man and the Channel Islands made the BVI a more attractive location.¹²

¹²Incorporation fee for an IBC with authorized share capital of 50,000 or less is US \$300 and annual license fee US \$300, for a company with a share capital of over US\$ 50,000 the incorporation and annual fee is US\$1000 each.

SECTION II

MACROECONOMIC ISSUES

Trends in Economic Growth and Employment

The impact of IBC revenues on economic growth and welfare is underscored by the increments in per capita GDP which increased from US\$2,540 in 1981 to US\$6,421 in 1985 and to US\$17,658 by the end of 1994. The revenues from IBC registration have increased their relative contribution to GDP from 1.6 per cent of GDP in 1984 to 14.7 per cent of GDP by the end of 1994 (Table 2). The growth in financial services industry has stimulated direct employment of approximately 500 in 1995 and indirect employment through the need for ancillary services. The construction sector in particular has benefitted from the increases in economic welfare by overcoming labour supply constraints through sourcing workers from the OECS. The percentage of the labour force in this sector increased from 11.6 per cent in 1980 to 13.5 per cent in 1991 (BVI Population Census, 1991). Notable increases in employment were also observed in transport and communication (from 2.9 per cent to 7.3 per cent), finance and real estate (from 5.5 per cent to 10.8 per cent) over the two benchmark periods.

In 1980, roughly 5.7 per cent of the labour force was employed in the agricultural sector while the services sector accounted for 80 per cent of the workforce. By 1991, the agricultural sector accounted for 2 per cent of the labour force. This decline arose from resource movements into the services sector, employment in which increased to 91.4 per cent. The structural impact of the boom in offshore activity is typical of the Dutch Disease phenomenon where a country experiences a boom in a sector that produces a good or service for which there is limited domestic demand. The increase in economic prosperity has also resulted in an increase in female labour participation in the work force from 59 per cent in 1980 to 69.8 per cent by 1991 (BVI Population Census, 1991).

IBC Revenues and Fiscal Performance

Fees from the Financial Services Sector have increased from 7.2 per cent of current revenue to 45.0 per cent in 1994 due primarily to the increasing level of IBC incorporations in the jurisdiction. (Table 1 and Figure 2). The acceleration in revenues was significant following the crisis in Panama in the early 1990's. While current revenue has grown in line with GDP, this has been on account of the strong growth in receipts from IBC registration. Current revenue averaged 24.1 per cent of GDP over the period 1984-89 increasing to 27.3 per cent of GDP during the subsequent 1990-94 period; a performance that exceeds the ECCB area average of 24.3 per cent over the latter period (Table 1). However on an individual country basis, St. Vincent and the Grenadines and St. Lucia are the only ECCB area territories that have attained a comparable level of revenues as a percentage of GDP based on a primary reliance on trade taxes.

Collections from taxes on income and profits have declined steadily as a per cent of GDP over the period 1984-94, ranging from 7.6 per cent in 1984 and levelling off at 5.2 per cent by the end of 1994. Similarly, taxes on international trade and transactions initially increased from 7.3 per cent of GDP in 1984 and peaked at 8.5 per cent of GDP in 1987. The yield from these taxes have not kept pace with growth in GDP and have declined markedly since 1990, gradually levelled off at 5 per cent of GDP in 1994 (Figure 3). Receipts from non tax revenue have never exceeded 2 per cent of GDP over the 1984-94 period. In the ECCB area tax receipts from this category of taxes average 3.6 per cent.

These contrasting performances in the various tax categories speak to weaknesses in collections and the need to bolster tax administration. Despite a low marginal rate of tax on corporate (20 per cent) personal income tax (3 - 20 per cent) and import duties (15 - 20 per cent), the degree of compliance is low. A considerable volume of trade among the US and British Virgin Islands escape taxation at ports of entry leading to leakage in tax revenue (Figure 3). This observation is underscored by the decline in revenues from international trade and transactions despite increases in economic activity. In addition, the level of technical expertise in the Inland Revenue Department (IRD) may be inadequate to fully assess taxes accruing to Trust Companies. Differences in tax assessment arise when not all income is declared within the

jurisdiction. Inertia in the collection of arrears also arise because of a general unwillingness to enforce collections in a small familial community setting. In recognition of this deficiency, the authorities have sought technical assistance from the British to strengthen the administrative and technical capacity of the IRD.

On the expenditure side, the pace of current expenditure growth has been contained. Expenditure growth averaged 14.2 per cent during 1984-89 compared with revenue growth of 19 per cent over the same period. The average growth in current expenditures (15.2 per cent) subsequently caught up that of current revenues (15.3 per cent) during 1990-94. The rate of growth in revenues reflected a larger revenue base which has been centred on the performance of the Offshore Business sector (Figure 4).

To achieve a higher level of savings in the future (averaging 5.3 per cent of GDP in the 1990's), the GOBVI will have to keep contain the growth in current expenditures which appears to be catching up with the growth in current revenues. Current expenditure as a percentage of GDP are in line with the ECCB area average for the period 1990-94. Greater expenditure restraint as demonstrated by the St. Lucian authorities over the same period can facilitate higher levels of savings (Table 1). Growth in expenditures on personal emoluments, goods and services and transfers have been the categories that have grown most rapidly, partly reflecting the need to pay higher wages in order to attract certain types of skills into the non-tradable government sector. The spending effects of IBC revenues are therefore manifested through higher personal emoluments which may not reflect increases in the marginal productivity of labour. Expenditures on transfers and subsidies have accelerated during the 1990's reflecting the deficit operations of the Water and Sewerage Department which will eventually be converted to a statutory body.

Public Sector Investment and Debt Accumulation

Capital expenditures have increased from 3.0 per cent of GDP in 1988, reaching a peak of 10.9 per cent of GDP by 1992 due to and stabilising at around 7.1 per cent of GDP by the end of 1994. The financing of higher levels of public sector investment has been associated with rising current account balances since 1987 enabling adequate counterpart financing for increasing

levels of public sector investment. The current account balance was 1.6 per cent of GDP in 1987 and improved consistently during the 1990's to 5.3 per cent by 1994, with the exception of 1991 when it fell to 1.7 per cent. This decline reflected the acceleration in current expenditures and a general contraction in economic activity during that year. These levels of current account savings are comparable to those of St. Lucia and St. Vincent and the Grenadines based on improved terms of trade for banana exports and growth in visitor arrivals.

The pace of public sector investment in the BVI accelerated during the 1990's commencing with the construction of the Central Administration Complex at a cost of \$18.2m. Public sector debt which rose from \$20.1m in 1989 to \$53.7m in 1994 has been achieved through the increased use of both external and domestic resources (Table 3). The domestic debt component which increased from 21.3 per cent (US\$5.7m) of total public sector debt in 1990 to 35.8 per cent (US\$20.4m) by 1994, was short term and commercial in nature. The associated debt service payment as a per cent of current revenue has declined from 9.8 per cent in 1990 to 4.8 per cent by 1994 reflecting the faster growth in revenues. However, US\$14.0m of the stock of debt outstanding at the end of 1993 was contracted with domestic commercial banks and principal payments which became due in 1995 were expected to increase the domestic debt service to approximately US\$3.5m per year.

Faced with the choice between using the windfalls from IBCs for investment versus consumption, GOBVI has sought to increase the level of public sector investment. While the receipts from IBC revenues have contributed to increases in capital expenditure, it is the efficiency of the investment that is questionable. Implementation ratios from 1991 to 1994 were 28.4 per cent, 72.3 per cent, 52.7 per cent and 48.3 per cent respectively. This performance was reflective of the unrealistic nature of the budgetary process. Implementation rates were 104.0 per cent in 1992, 31.8 per cent in 1993 and 17.0 per cent in 1994 suggesting possible weaknesses in technical and administrative capacities. Moreover, low and variable implementation rates suggest the need for closer integration of investment programming, the budgeting process and debt management. To address weaknesses in project implementation, the GOBVI established a technical committee to oversee project preparation, management and implementation with a view to providing periodic updates on the status of new and on-going projects.

Stabilisation Issues

The growth in revenues have persisted despite weaknesses in tax administration. Growth has been based primarily on the receipt of revenues from the Offshore Financial Services sector. By the end of 1994, receipts from IBC revenues had accounted for 45 per cent of central government revenues (\$37.7m). As a result of this dependency, the degree of tax effort has stagnated and non-IBC tax revenue has not grown in tandem with economic activity (Figure 3). To avert potential instability caused by external shocks the GOBVI needs to consider the building up of a reserve fund to smooth fluctuations in income arising from external shocks. Any significant shock to revenues as a result of a scandal in the Offshore Financial Sector or disruption in the vital tourism sector due to hurricanes will result in economic contraction. Similarly, the performance of the current account of the balance of payments, is dominated by net inflows into the travel, financial services and other business services sub-accounts.

The long run destabilizing effects of poorly managed commodity booms in oil-exporting developing countries such as Nigeria and Trinidad or of the coffee producers such as Colombia, Cote Ivoire and Kenya can serve as examples (Engel and Meller, 1993). The management of the revenues should be based on keeping current expenditures in line with the expected long-run revenues versus the temporary growth in IBC receipts. The GOBVI can base expenditures on a certain percentage of revenues derived from IBCs and the difference between the targetted level of current spending and revenue can be saved. The costs associated with assuming that receipts from IBC revenues are permanent, include the misallocation of resources, particularly certain types of labour into the Offshore Financial Services and non tradable sectors away from tradable sectors such as tourism.

Deciding whether the surge in IBC revenues is temporary rather than permanent can be based on the competitiveness of the Offshore Financial Services global market, maturity of the jurisdiction over time and vulnerability to natural disasters. Uncertainty in future market developments and the risk of scandal represent an opportunity cost that can be traded off against forced savings which serve as a precautionary motive for building up reserve funds.

The GOBVI currently, allocates a proportion of savings to capital expenditures (averaging 7.6 per cent of GDP in the 1990's), and to liquidate outstanding debt, but has so far not increased official reserves. In a jurisdiction where there is no Central Bank, GOBVI will increasingly have to find ways of sterilising the monetary base. The authorities may wish to consider issuing Development Bonds as a means of mobilising savings for future capital investment as well mopping up excess liquidity in the financial system. Development bonds can act as a mechanism for smoothing consumption over a longer time horizon.¹³ Cuddington, (1986), argued -

“to avoid the problem of overspending, a simple rule of thumb can be employed: limit the increase in national consumption expenditures to the annuity-equivalent of the windfall gain”

The choice between utilising savings by investing locally rather than in foreign assets is based on the rate of return on the investment and the question of the absorptive capacity of the economy. To sustain future economic development, capital expenditure will increasingly have to be funded using domestic savings and external loan financing, reflecting the expected decline in capital grants. The last tranche of capital aid from the British Government was disbursed during the 1989-93 period.

Economic Diversification of Services

In order to minimise economic vulnerability, the GOBVI has sought to broaden its financial services product base to encompass company trust formation (Trustee Amendment Act 1993), mutual funds (1995 Act) and more recently insurance companies (Insurance Act 1994 and Insurance Regulations 1995). In the latter product, niche sectors such as the medical industry and workers compensation are being targeted. This strategy is being crafted in the context of limited potential in the agricultural and manufacturing sectors.

In the wider services sector, expansion in tourism is being constrained by existing facilities. The attraction of new direct investment in tourism is predicated on increased

¹³ If the marginal utility of consumption declines with the level of consumption, an individual's utility will be higher if the increased consumption is spread over time (Hill and Mokgethi (1994).

marketing and promotion and the expansion of the existing airport. The importance of the tourism sector is reinforced by its relative contribution to GDP (20-25 per cent), gross foreign exchange earnings of US\$135m at the end of 1994 and employment of 21 per cent of the labour force..

SECTION III

LESSONS AND PROSPECTS FOR ECCB AREA TERRITORIES

The OECS countries have now entered a period of great economic uncertainty after the golden decade of the 1980's when relatively high rates of growth were achieved. The development strategy of these economies has been based principally on the production of traditional crops for exports to protected markets and promoting the attractiveness of the region as a holiday destination.

These countries' ability to maintain the necessary infrastructure to support private sector activity was facilitated by the high levels of concessionary funds made available by bilateral and multinational institutions for the purpose of financing much needed development oriented projects. These funds were complemented by an influx of foreign direct investment into these economies.

Despite the favourable economic performance of these countries, the question of vulnerability and the need for diversification have always been a major issue. Recent and expected changes within the global environment have made it imperative that these issues be addressed. The uncertainty within the banana industry a major generator of foreign exchange is of great significance, given the strong American lobby and the expected eventual removal of existing protective barriers in Europe. When the barriers are removed, barring major restructuring of the industry, the Windward Islands would be marginalised in the market, given present uncompetitive cost structures.

Of equal significance is the decline in concessionary aid available to developing countries due mainly to the diversion of funds to Eastern European countries and the graduation of several Caribbean countries from "soft window" facilities. These developments are underscored by the decline in total net flows from official sources from US \$70 per capita between 1980-82 to US

\$31 per capita between 1990-92.¹⁴ This development has serious implications for the financing of capital expenditures as possible alternatives are the use of commercial loans, increase current domestic savings, decrease capital expenditures or acquire non-debt capital flows.

The acquisition of non-debt capital flows is very appealing and is an avenue which is being continuously exploited by governments of the region. One avenue to attract non-debt flows which can be strengthened is the development of the ECCB area territories as OFCs, thus developing the islands into service economies. A number of the ECCB area countries have taken the initiative and have passed or intends to enact legislation to govern the industry. The Leeward islands are at present more involved in the industry than the Windward islands, with Antigua, Nevis and Anguilla emerging as OFCs.¹⁵ The financial service industry is a fast growth industry and the demand for credible centers is projected to continue increasing. However, as more countries enter the industry it will become increasingly competitive and more innovative measures will have to be developed by countries, especially the new entrants.

Required Conditions

For the ECCB area countries to enter the offshore industry on a competitive basis, the incentives provided must be similar to or much more improved than what is already provided in existing offshore centers. The offshore sector is extremely volatile and what is important is for the countries to have the relevant infrastructure in place in order to take advantage of spillover effects within other markets (e.g. Hong Kong) or natural growth in the demand for offshore centers. It is estimated that in excess of US\$5 trillion is held in OFCs and that at least 60 per cent of all international business transactions utilise offshore jurisdictions (Mathavious, 1994a).

¹⁴See World Bank report 1994 pg. 35

¹⁵For further information on offshore sector activity in the OECS, see Offshore Financial Services with special reference to Banking especially pg. 1-5, 25-27 and appendix 1(A),

Examination of highly successful OFCs reveals that these centers have in common the following group of conditions¹⁶:

- (a) Economic and Political stability;
- (b) Stable and convertible currencies;
- (c) High standard of literacy;
- (d) Favorable Tax investment Climate;
- (e) No direct taxation or foreign exchange controls for international businesses;
- (g) No restrictions or repatriation of capital gains tax;
- (h) No income, dividends, or capital gains taxes;
- (i) Sophisticated domestic and international banking services;
- (j) Availability of professional services (CPA, CFA, Legal);
- (k) State of the art telecommunications facilities;
- (l) Pro Business Government platform;
- (m) Capacity and infrastructure to accommodate offshore activities; and
- (n) Excellent Government/Business/Labor relations.

The ECCB area countries satisfy a number of the conditions identified as important to the development of OFCs, for the others the required legislation must be enacted. In the context of capital market development in the ECCB area, the development of some financial service products can serve as a means of diversification of the export service base. It is not anticipated that these territories will emerge as premier OFCs over the medium term, however there is a need to institute a strong regulatory framework to safeguard the reputation of economic stability. The presence of British oversight in the operations of the financial services sector in the dependent territories, has facilitated their development by engendering a measure of stability. At present the ECCB has some regulatory expertise which can be utilised in advising the respective Ministries of Finance in regulating the sector.

¹⁶ OECS territories already satisfy conditions (a), (b), (c), (d), (i), (k), (l) and (n).

The process of supervising and monitoring the industry is a continuous activity, however some of the screening and regulation can be provided by a group which have a vested interest in ensuring that the jurisdiction remains credible. This type of self-regulatory organisation is available within the BVI, namely the Association of Registered Agents. Hence in developing the industry in the ECCB area the policy makers can actively promote the establishment of such an institution to assist with monitoring the sector. The Channel Islands and the Isle of Man have moved towards establishment of a supervisory agency comparable to the operations of the ECCB. Ferracho-Williams and Samuel 1996, explore the costs and benefits associated with alternative regulatory structures for the OECS. The BVI likewise is considering the additional costs associated with developing such an entity in light of the channelling of over US\$50 billion in mutual funds through the territory. In addition in order to attract personnel with the required regulatory skills, the level of remuneration ought to be comparable to that offered by the sector being regulated in order to avoid poaching of these skilled personnel.

One of the major issues which will have to be addressed by ECCB member territories in light of the BVI experience is the timely drafting and enactment of the required legislation. Therefore policy makers within the OECS may have to consider contracting domestic or regional private sector experts to provide consultancy services to the Attorney General and the legal department. This strategy was pursued by the BVI in overcoming these constraints within the public sector.

Fiscal and Labor Market Issues

The OECS territories will benefit from the ongoing institutional strengthening of the Treasury and Inland Revenue Departments under the Economic Management Project (ECEMP). The computerisation of budgeting and cashiering operations in addition to the gradual move towards programmed budgeting will assist in better management and prioritisation of budgetary resources. This development is complementary to any new sources of revenue that may arise from the development of the offshore financial sector in these territories. The containment of expenditures is critical given the need to generate higher levels of public sector savings to finance

investment activities and the tendency of government expenditures to grow over time in line with income (Wagner's Law).

Wage pressures within the public sector arising from demonstration effects in the offshore sector will therefore need to be based on productivity, inflation and the consideration of non wage benefits. Increases in cost of production arising from wage increases are likely to result in a real appreciation of the currency and contribute to reduced competitiveness. However practicing wage restraint might be difficult as resource movement effects may result in a transfer of human resources from the public sector to the offshore sector. To restrict such movements and to enhance political popularity government might be tempted to use "efficiency wage" policies to retain employees. The relatively high levels of unemployment in the region is unlikely to mitigate these effects as the offshore sector demands skilled labor which is available mainly in the public sector.

The effects of Dutch Disease have been apparent in the BVI given labour movements out of the agricultural sector and the increases in wages in the public sector. The price and resource movement effects are more likely to have a greater impact on the agricultural sector in the OECS where this sector contributes more to value added compared with the BVI. The impact on the banana industry are likely to be indirect and related to the strength of the spending effect. If the spending effect is sufficiently strong it could induce price increases within the non-traded sector (construction, distribution) resulting in a gradual movement of workers out of the banana industry. The force of the spending effect is likely to be muted due to the availability of a large reserve pool of unskilled labor in the region. One of the disadvantages of increased economic growth in the BVI has been the need to import skills from neighboring territories resulting in non-BV- Islanders comprising over 50 per cent of the population. This problem is not likely to arise in the OECS, however, it has given rise to a number of social problems in the BVI.

The current examination of the education sector in a number of ECCB are countries under the aegis of the Basic Education Project with a view to reform management, curriculum development and improved physical infrastructure is complementary to the evolution of these economies as service based. Identification of future manpower needs will enable better

prioritisation of education expenditures for the purposes of training and Human Resource Development (HRD).

The case for a fiscal reserve or stabilisation fund regardless of the state of progress in the development of the financial services sector in the OECS was forcefully manifested in 1995 with the advent of several destructive hurricanes. The vulnerability of small island economies to shocks in export earnings arising from natural disasters, real exchange rate and export price risks reinforces the need to develop such a facility.

CONCLUSIONS

The success of the BVI as an OFC has been based on its development of the necessary legal and physical infrastructure, emphasis on HRD and a measure of financial and political stability engendered from being a dependent territory of the U.K. However, its management of the windfall revenues from the financial services sector illustrates that success can be detrimental to the efficacy of tax administration and containment of expenditures on personal emoluments. The dependency on revenues from this sector confers a high degree of vulnerability to external shocks. In light of this vulnerability, the authorities need to examine the establishment of a stabilisation or fiscal reserve fund. ECCB area territories that are considering the development of the financial services sector can learn from the experience of the BVI by putting effective budgetary processes in place, augmenting their HRD capabilities and strengthening both legislation and regulation of this sector.

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Table 1. Central Government Operations as a Per Cent of GDP Market Prices

Item	BVI					ST. LUCIA					ECCB				
	1990	1991	1992	1993	1994	1990	1991	1992	1993	1994	1990	1991	1992	1993	1994
Current Revenue	26.2	22.4	24.8	27.1	27.9	24.8	25.6	25.3	26.0	25.7	24.6	24.3	24.1	24.4	24.2
Tax Revenue	24.1	22.4	22.9	25.7	26.2	23.0	23.6	23.3	22.4	23.1	21.1	21.0	20.5	20.6	20.5
Tax Income & Profits	5.3	5.6	5.2	5.3	5.2	6.4	6.7	6.7	6.2	6.6	4.4	4.5	4.6	4.3	4.5
Taxes on International Trade & Transactions	7.9	5.4	5.0	4.9	5.1	13.9	15.4	14.4	13.9	11.7	13.1	12.5	12.0	12.2	12.0
Non Tax Revenue	1.5	1.2	1.9	0.9	1.7	1.8	1.9	2.0	2.9	2.6	3.4	3.3	3.6	3.8	3.7
Current Expenditure	21.7	21.8	20.3	22.4	22.6	19.0	19.2	18.7	18.6	19.7	22.2	22.4	22.0	21.7	22.0
Personal Emoluments	12.1	11.3	9.8	10.6	10.1	9.9	9.7	9.5	9.8	10.4	11.6	11.6	11.7	11.6	11.6
Goods and Services	6.6	6.8	6.9	6.8	7.1	3.9	4.4	4.1	3.9	4.2	5.5	5.6	5.3	5.2	5.3
Transfers & Subsidies	2.9	3.5	3.4	4.4	4.8	4.4	4.3	4.4	4.1	4.4	2.1	2.1	2.0	1.9	1.9
Interest Payments	0.8	0.8	1.0	0.7	0.5	0.8	0.7	0.8	0.8	0.8	3.0	3.1	3.1	3.0	3.1
Capital Expenditure	7.0	6.2	10.9	6.9	7.1	9.7	19.2	18.7	18.6	19.7	6.9	6.1	5.9	6.7	6.2
Current Balance	4.5	3.0	4.5	4.8	5.3	5.8	6.4	6.6	7.4	5.9	2.4	1.9	2.0	2.7	2.2
Overall Balance	-1.4	-2.2	-5.2	-1.1	-1.1	0.8	0.6	-1.2	-0.6	-0.9	-2.6	-1.4	-1.8	-1.3	-1.7

Source: Development Planning Unit and ECCB

Table 2. Selected Information on the Financial Services Sector

Item	1990	1991	1992	1993	1994
Total Fees Financial Services Sector (US\$M)	16.9	22.5	23.1	28.9	37.7
Bank and Trust Co. License Fees (US\$M)	0.1	0.1	0.1	0.3	0.4
IBC Fees (US\$M)	16.8	22.4	23.0	28.6	37.3
New IBC Registrations	15,322	15,955	20,795	28,618	32,823
Cumulative Total	37,921	53,876	74,671	103,289	136,112
<u>Memorandum Items</u>					
Financial Service Fees (%GDP)	8.6	9.6	11.2	14.0	14.7
Financial Service Fees (%Revenue)	35.2	43.0	38.1	40.3	45.0
Visitor Expenditure (US\$M)	132.1	109.4	109.4	122.0	135.0

Source: Financial Services Inspectorate BVI and CDB

Table 3. Public Sector Debt (US\$M)

Item	1990	1991	1992	1993	1994
Total Public Sector Debt	26.7	36.4	54.2	54.8	53.7
External	21.1	27.2	34.3	34.4	34.5
Domestic	5.7	9.3	19.9	20.4	19.2
Total Public Sector Debt Service	4.7	3.7	4.9	3.9	4.0
External Debt Service	4.5	3.2	4.0	2.0	2.5
Amortisation	0.5	1.5	1.6	0.8	1.0
Interest	4.0	1.7	2.4	1.2	1.5
Domestic Debt Service	0.2	0.5	0.9	1.9	2.5
Amortisation	0.0	0.0	0.0	0.7	1.0
Interest	0.2	0.5	0.9	1.2	1.5
<u>Memorandum Items</u>					
Total Public Debt (%GDP)	14.5	17.3	22.2	20.7	18.0
Total Public Debt Service (%Revenue)	9.8	7.1	8.1	5.4	3.8
Total Public Debt Service XGNFS	3.1	2.8	3.7	2.6	2.5

Source Caribbean Development Bank

Figure 1. Caribbean Offshore Financial Centres Company Formations in 1993

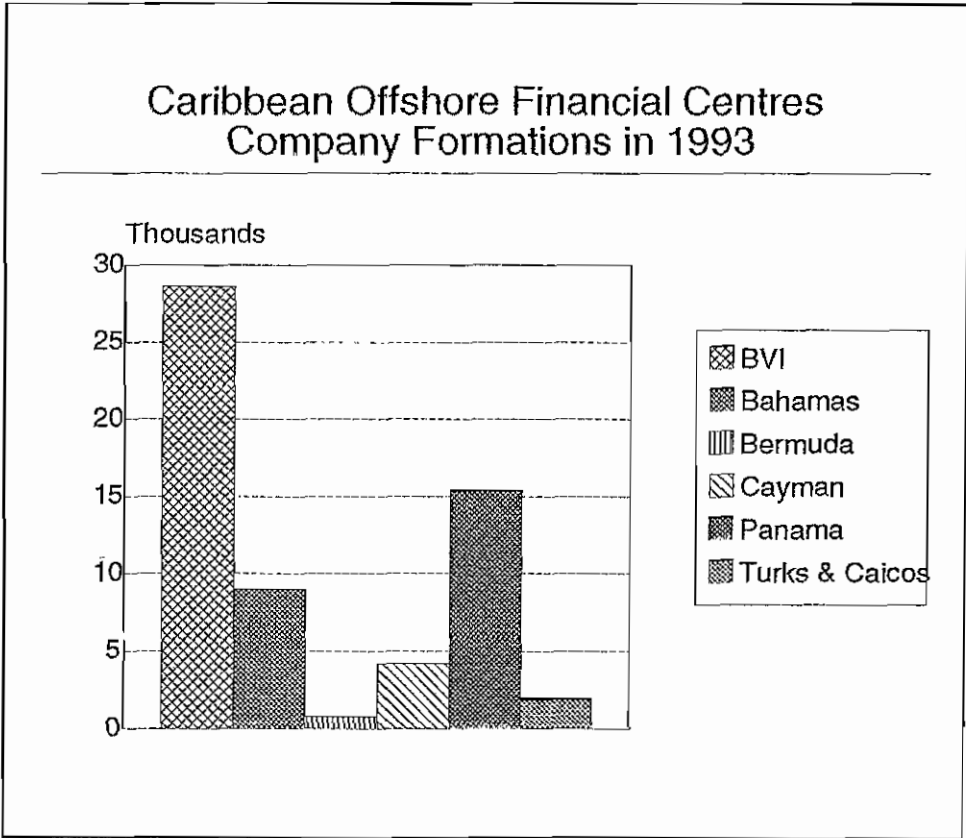


Figure 2. BVI IBC Incorporations and Revenues

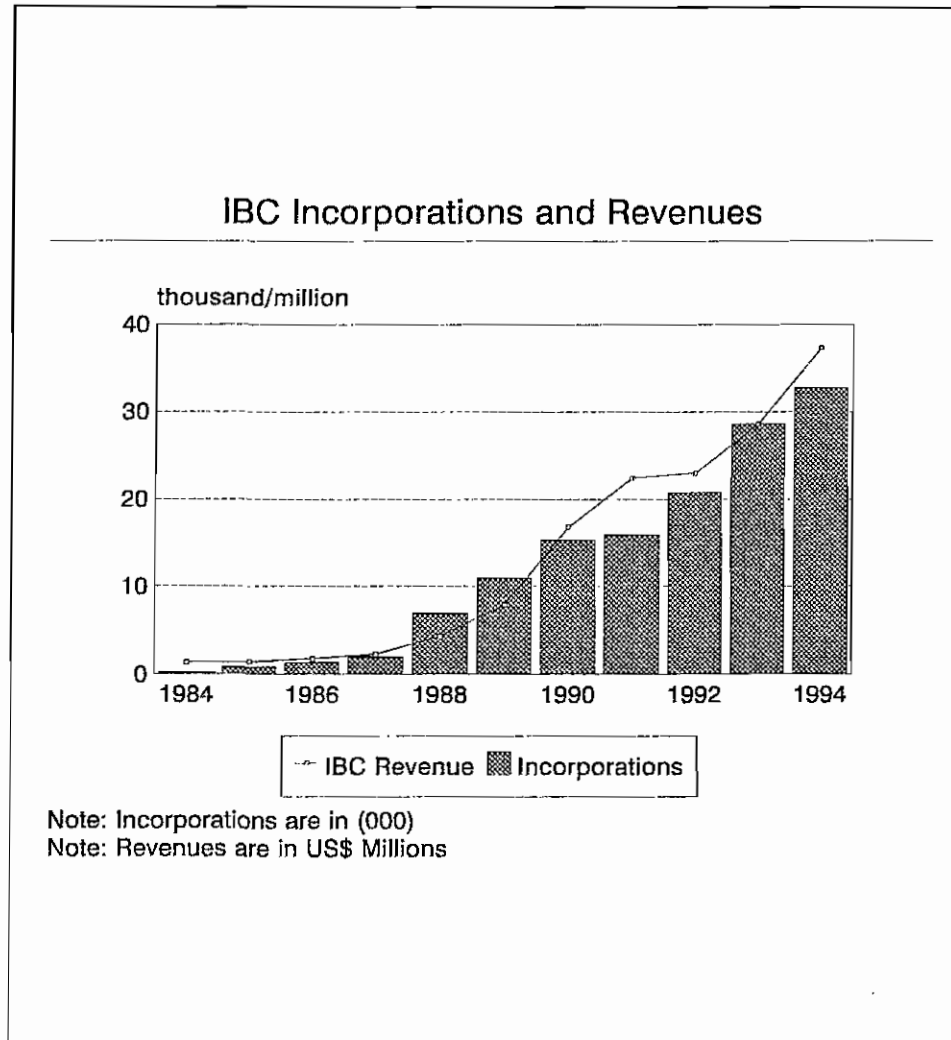


Figure 3. BVI Central Government Selected Taxes as a Per Cent of GDP Market Prices

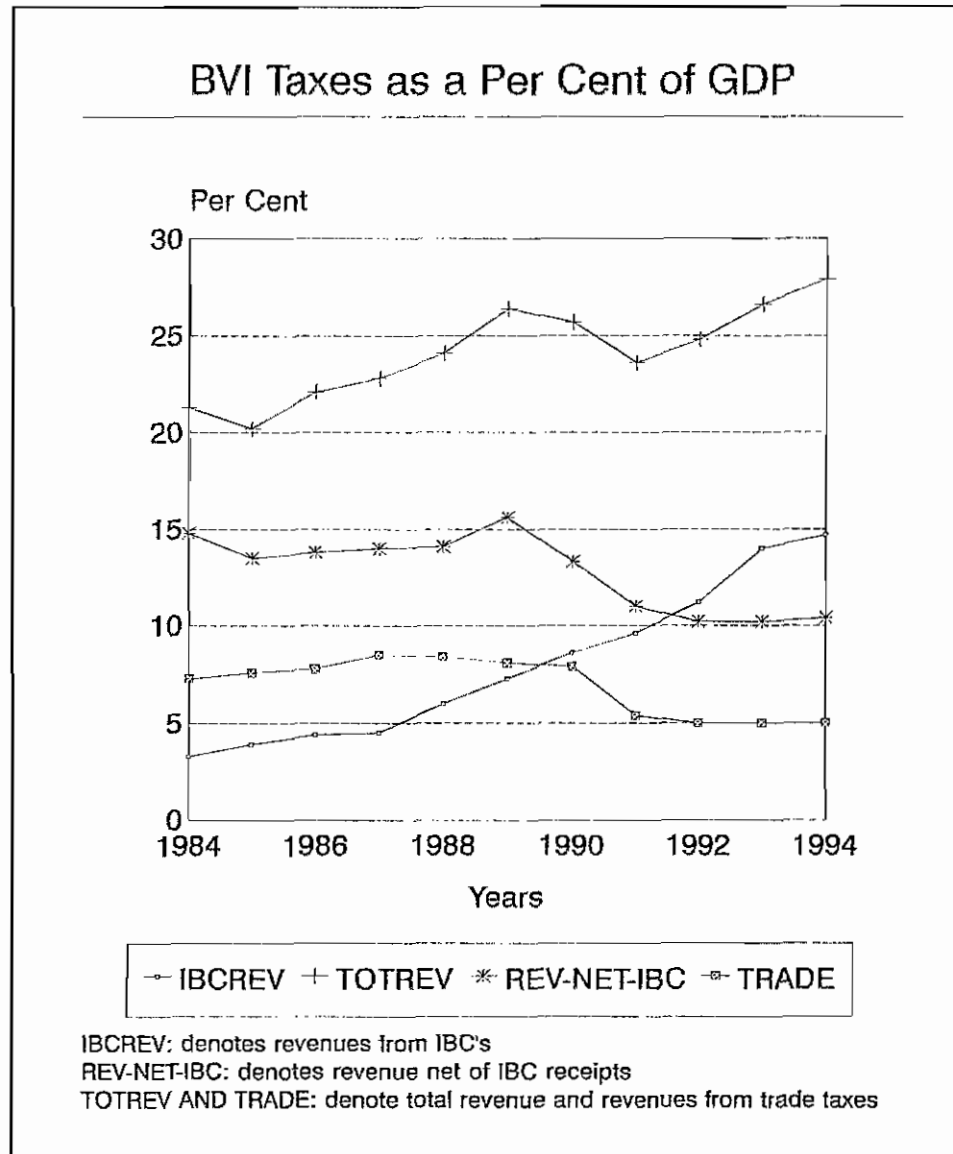


Figure 4. Growth in BVI Central Government Revenues and Expenditures

