

FEATURES

OFFSHORE BANKING CENTRES: BENEFITS AND COSTS

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An analysis of offshore banking centres finds the major benefit attached to hosting offshore banks to be their local operating expenditures, to the extent that these contribute to domestic welfare. Estimated operating expenditures are as high as 8 per cent of the host country's gross national product (GNP) in some centers. This benefit appears to be only loosely related to the volume of business routed through a center but closely related to the number of banks and the types of operations carried out. Countries with smaller economies gain proportionately more from offshore banking than those with larger ones. However, in addition to the benefits from local expenditure, there may also be substantial direct and indirect costs associated with the regulation and control of offshore centers. The major potential indirect cost is the possible adverse impact of offshore banks' activities onshore. However, as long as offshore banks operate entirely offshore, it is impossible for flows of funds through them to influence the domestic monetary system; and if onshore activities are permitted, they will only cause problems if the authorities are unable to control them.

THE OFFSHORE CENTER

This article defines offshore banking centers places—whether countries, areas, or cities—which have made a deliberate attempt to attract international banking business (nonresident, foreign-currency denominated assets, and liabilities) by reducing or eliminating restrictions upon operations as well as lowering taxes and/or other levies. Approximately 21 centers qualify under this definition (see Table 1 for more detailed information).

Offshore centers may be classified as either "paper" or "functional." A paper center acts as a location of record, but little or no actual banking is carried out there, whereas a functional center is one where deposit taking or final lending is actually carried out. Functional centers serve as important links between Eurocurrency markets, helping to channel funds from major international financial

In 1965, the total Eurocurrency market was estimated at \$9 billion (net), and the offshore centres accounted for a negligible share of this total. By 1978, the Eurocurrency market had grown to \$375 billion (net), and the group of financial centres included under the rubric of offshore centres accounted for \$45 billion of this. Over the last two decades, there has been a striking growth in international financial markets in general and the Eurocurrency market in particular. This growth has been facilitated by, and to some extent has precipitated, a market increase in the number of offshore banking centres.

The striking increase in the importance of offshore centres largely reflects the advantages they offer vis-a-vis more traditional centres, although in many ways the offshore centre should be seen as adjuncts to these traditional centres rather than as solely competitors. Indeed the distinction between major international financial centers, such as London and New York, and offshore centers, such as Bahrain, Luxembourg and Singapore, is to some extent an arbitrary one. For example, London offers many of the same advantages for Eurocurrency business, in terms of freedom from reserve requirements and interest withholding taxes, that Singapore does; while New York authorities have been exploring the possibility of establishing a "banking free zone" in which banks dealing with nonresidents would be exempt from minimum reserve requirements, interest rate controls, and interest withholding taxes.

This article from the IMF/World Bank quarterly Finance and Development, analyzes the benefits and costs of hosting offshore banks in general terms, drawing, where appropriate, upon the experience of several offshore centers. It does not however, attempt to deal with the implications of offshore banking activities for other countries or for Eurocurrency markets, nor does it deal with the benefits and costs of operating tax havens. (See "Tax Havens Explained" by Milka Casanegra de Jantscher, Economic Review, January, 1978).

centers (such as London and New York) to final borrowers; in contrast, paper centers are basically used by international banks to minimize overall taxes and other levies.

Despite the apparent heterogeneity of the centers, they do have some characteristics in common. First, in virtually all of the centers, local capital requirements—which must be held in the form of onshore assets, whether government paper or bank premises—are low or nonexistent for offshore banks. Second, license fees are generally low. Third, entry is relatively easy, especially for large international banks, in contrast to the situation in neighboring countries, which may strictly limit or prohibit the entry of foreign banks. Fourth, and most important, taxes and levies on offshore business are virtually nonexistent in these centers, in marked contrast to the situation in alternative locations. None of the centers imposes minimum reserve requirements on offshore

liabilities or withholding taxes on internal income. Only four impose profit taxes, and these are very limited. Moreover, some, but not all, offer the advantage of proximity to important loan outlets or deposit sources; Bahrain, for example, is an offshore base for petrodollar transactions.

DEMAND

The demand for offshore centers by banks in general increases with the severity of taxes, levies, and restrictions imposed by authorities in onshore centers. For example, if New York—now an onshore center—were to exempt banks' operations with nonresidents from minimum reserve requirements and other charges, then banks would be less attracted to paper operations in offshore centers such as the Bahamas. Of course, in a sense, this would merely mean that New York had become a new offshore center rather than any diminution in overall offshore business.

TABLE 1

FIFTEEN OFFSHORE BANKING CENTERS: SOME BASIC DATA

	Ease of entry	Local capital requirements	Taxes and levies	Annual license fees	Number of offshore banks	Total offshore assets (in billions of U.S. dollars)
Anguilla	Until now, unregulated.	None	None	EC\$1,350	100	..
Bahamas	Relatively easy, even for new banks.	None	None	US\$300-45,000 ¹	263	70
Bahrain	Generally limited to branches of major international banks.	None	None	US\$25,00	37	21
Cayman Islands	Relatively easy, even for new banks.	None	None	C\$5,000-15,000	260	12 ²
Hong Kong	Foreign banks are now being licensed after a 13-year moratorium. For the most part, only one branch of large international banks will be allowed.	None	10% withholding on interest paid. (proposed 17% offshore profit tax).	..	74 ³ 200 ⁴	11
Jersey	Only large, reputable international banks have been admitted	None	£ 300 per annum for corporate tax companies	..	33	2
Lebanon	Foreign banks must deposit LL 7.5 million with the Treasury. Other new banks must have 50% Lebanese ownership and deposit LL 4.5 million.	LL 15 million	None	..	78	..
Luxembourg	Only large, reputable international banks have been admitted.	Lux F 250 million	40% corporate tax 40% municipal business tax. 30% liquidity ratio. 3-6% profit tax.	..	92	48
Netherlands Antilles	Extremely easy.	None	No liquidity requirements.	..	42	..
New Hebrides	Extremely easy.	None	None	\$A 1,00	13	..
Panama	Relatively easy for branches or subsidiaries of international banks.	US\$250,00	None	None	66	7
Philippines	Limited entry until profitability of existing operations has been assured. Major international banks favored.	US\$1 million ⁷	5% profit tax (on offshore to offshore transactions) 10% profit tax (on shore to on-shore).	US\$20,000	17	1
Seychelles	Limited to branches of subsidiaries of major international banks	None	None ⁶	US\$20,000 ⁵	1 ⁸	..
Singapore	Relatively easy. Major international banks favoured	S\$3 million	10% profit tax (on offshore operations).	S\$50,000	66	17
United Arab Emirates	Restricted licenses are limited, in theory, to reputable international banks.		None (at least in the Emirate of Sharjah).	None	55 ⁹	..

Sources: Material from The Banker, Banker Research Unit, Euromoney, Fa, Eastern Economic Review, Sunday Times.
 Note: Six centers are not listed because data are either insignificant or unobtainable. These are Barbados, Costa Rica, Guernsey, the Isle of Man, Nicaragua, and St. Vincent.
 ... Indicate that data either insignificant or unobtainable.

If major countries coordinated their taxation, bank supervision, and application of reserve requirements, then tax avoidance via routing transactions through offshore banking centers would be more difficult and less rewarding, but even if this were to happen, functional offshore centers would still offer some advantages.

The volume of business routed through offshore centers has increased with the growth of Eurocurrency transactions of the participating institutions, at least so long as the offshore centers have provided fiscal advantages to offshore banks and enacted fewer regulations than elsewhere.

The demand for individual paper centers is quite sensitive to minor changes in local charges and regulations. Paper centers are obviously extremely close substitutes for one another in today's world of modern telecommunications. As long as a bank has little physical presence in a center, it is fairly easy to relocate operations if one center tries to impose slightly higher charges than the others. This is particularly the case where international banks have banking operations in several paper centers.

The demand for functional centers is less sensitive to local taxes and levies. Functional centers generate profits in their own right rather than solely via the avoidance of taxes and levies elsewhere. Moreover, they are not close substitutes for one another, and banks, because of their physical presence in the centers, will incur more substantial costs if operations are closed. The functional centers, therefore, have been able to impose profit taxes on offshore banks.

Lastly, once a center, particularly a functional one, attracts a sufficient number of banks, its attractiveness to other banks increases automatically. There is thus what might be seen as a takeoff point. Once a sufficient number of banks are attracted, substantial external economies may result—for example, it may become economic to provide newcomers with the services of accountants, lawyers, and moneybrokers, and communication with other trading or correspondent banks may become easier.

In recent years, there has been a proliferation of ministates, and many of them have developed an interest in hosting offshore banks, whether paper or functional. However, most of them are better fitted to act as paper centers, since they often lack both a favorable location and the requisite financial and communication facilities. Given the proliferation of paper centers and the broadbased coverage provided by existing functional centers, it is unlikely that the recent increase in their supply will be matched by an equivalent increase in demand for them. The prospects for new centers are therefore limited.

OPERATING EXPENDITURES

The number of countries willing to act as offshore centers is clearly related to their perceptions of the costs and benefits involved. Ideally, a country's decision to specialize in offshore business—to introduce the requisite amendments to legislation, to invest in telecommunications and infrastructure, and to accept the potential indirect costs—would depend upon an explicit assessment of the expected future net welfare gain, discounted over time. In practice, however, there are many uncertainties and inherent difficulties in

quantifying many of these costs and benefits. All that a country's authorities can do is to list the potential costs and benefits and make an ad hoc assessment as the opportunities occur to host these banks.

Offshore banks pay salaries and incur local expenditures which contribute to the welfare of the host economy. Available evidence suggests that this is normally the major contribution of offshore banking to the host country. Care must be taken, though, to distinguish between the gross and net benefits. If salaries are paid to expatriates who import most of their consumption needs, there is little or no benefit to the domestic economy other than profits for importers and import taxes paid to the government. On the other hand, if salaries are paid to local employees and they spend a relatively insignificant proportion of them on imports, the net welfare gain will be far greater.

Various estimates of the direct benefits attributable to offshore banks in the Bahamas, Bahrain, Panama, and Singapore are summarized in Table 2. These are relatively more important, as might

Table 2, Five host countries: gross direct benefits ascribable to offshore banking
(In thousands of U.S. dollars)

	Salaries	Other Expenditure	Total Expenditure	Licence and Other Fees	Profit Taxes
Bahamas¹					
1973 ...	17,093	13,025	30,118	1,545	n.a.
1974 ...	17,195	12,935	30,130	1,515	n.a.
1975 ...	18,330	14,556	32,886	1,508	n.a.
Bahrain²					
1977 ...	...	...	20,800-40,000	800	n.a.
1978 ...	...	...	37,650-50,000	875	n.a.
Cayman Islands¹					
1976 ...	4,898	4,040	8,938	957	n.a.
1977 ...	5,340	4,879	10,219	1,501	n.a.
Panama³					
1974 ...	2,268-15,919	1,711-12,009	2,977-27,928	—	n.a.
1975 ...	2,405-21,506	1,814-16,224	4,103-37,703	—	n.a.
1976 ...	3,564	2,689	6,253	—	n.a.
Singapore					
1974 ...	...	...	12,000 ⁴ -127,900 ⁵	1,200	2,700-4,100 ⁶
1975 ...	...	...	15,700 ⁴ -131,000 ⁵	1,200	3,300-5,000 ⁶
1976 ...	...	...	21,300 ⁴ -151,100 ⁵	1,300	4,600-6,800 ⁶

n.a. indicates that data are not applicable.

... Indicate that data are either insignificant or unobtainable.

- 1 Information provided by the monetary authorities.
- 2 Based on published estimates.
- 3 Estimated on the basis of employment figures provided by the authorities.
- 4 Estimated using the assumption that operating expenditures equalled 0.05 per cent offshore assets (Bank of America's estimated cost of Eurocurrency business according to N. Colchester, "Counting the Cost of Lending," Financial Times July 15, 1978).
- 5 Estimated by prorating the share of Asian Currency Units (ACUs) in the financial sector's share of GNP according to ACU's share of external assets.
- 6 Estimated on the basis of commercial bank's company reports.

be expected, for the smaller economies. Although the absolute amounts involved are unimpressive by the standards of international banking, they are not insignificant from the point of view of the countries involved.

For the Bahamas, offshore banks' expenditures amounted to 6.2 per cent of GNP and were second only to tourism in economic importance. For the Cayman Islands, these expenditures amounted to \$10 million, whereas tourism, the major economic activity, contributed \$22 million to the economy. The benefits do not appear to have been closely related to the level of offshore assets held by the banks. For example, the Bahamas shared in the rapid growth of Eurocurrency markets between 1973 and 1975 (the Bahamas and the Cayman Islands together accounted for \$26 billion in Eurocurrency assets in 1973 and \$50 billion in 1975); yet, despite a 90 per cent increase in business routed through the two centers, the offshore banks' local expenditures increased only 9 per cent. Similarly, the assets of the offshore banks in Bahrain doubled between 1977 and 1978, while their estimated expenditures increased only 20-25 per cent.

TAXES AND LEVIES

By imposing charges upon the banks—through license fees, profit taxes, or liquidity and capital requirements (to be satisfied by holding onshore assets)—the local authorities may, in theory, appropriate some of the benefits which the international banks derive from locating their operations in the offshore centers. Their ability to do so will depend upon the magnitude of these benefits to the banks concerned and the pressure of competition from other offshore centers. Paper centers have generally found it difficult to levy any charges other than license fees, but four functional centers—Luxembourg, the Netherlands Antilles, the Philippines, and Singapore—have been able to levy profit taxes on offshore banks. (A fifth center—Hong Kong—has announced an intention to do so). For three of the four centers, the amounts raised have not been impressive, with the exception of Luxembourg, where the Compagnie Luxembourgeoise de la Dresdner Bank is the largest single taxpayer and offshore banks contribute a

major share of corporate taxes. For Singapore, the yield from its 10 per cent profit tax is probably between \$5 and \$7 million annually, while the Philippines has so far gained nothing, since its offshore banking units have been making negligible profits.

License and other fees, such as work permit and registration fees, have similarly yielded relatively low returns. None of the centers appear to have derived much more than \$1.5 million per annum, and many have derived less. Other charges and levies are unimportant for the most part.

Even if the direct benefits of offshore banking are not as substantial as has generally been thought, there may still be significant indirect benefits. The centers may gain improved access to international capital markets; the domestic financial system may become more efficient, both through increased competition and through exposure to the practices of the offshore banks; and a cadre of local staff may be trained which will contribute to a faster growth of the domestic economy.

However, these benefits may not necessarily materialize. Since only "brass-plate" operations are being carried on in the paper centers, the larger functional centers will probably be better able to profit from improved interaction with international markets or from the competition to domestic banks from offshore operations. (Brassplate operations refer to those where the only sign of a bank's presence is a brassplate outside an office; such offices may administer the affairs of several banks.) However, countries which are able to act as functional centers generally have both excellent access to international markets and fairly well-developed domestic financial systems to start with.

As for the benefits from training a cadre of local staff, first, the expertise gained in offshore banking may not be relevant to the local financial system. Second, once bankers are trained, they may opt to stay with the offshore banks, in which case they may even be an internal "brain drain".

COSTS

Many countries view offshore banking as offering a ra-

pid and cheap means of garnering revenue for the economy and the government. There are, however, a number of costs which must be borne. These will depend upon both the character of the business which the center attracts and the characteristics of the local economy.

A brass-plate center may not incur any real costs, but the benefits will be correspondingly low. A center which aspires to become an important functional center may need to incur direct costs, such as expenditures on telecommunications, education, supervision, and regulation, while success may also entail several indirect costs, the most important of which are the diminution of autonomy of domestic monetary policy and, perhaps, increased tax evasion by businesses and individuals.

If a center is to attract offshore banks, the most important precondition is good communications; for remote areas, the cost of upgrading telecommunications may be high. Expenditures on education and training of local personnel may also be necessary in order to derive any concrete benefit from the presence of offshore banks. Last, the supervision and regulation of offshore banks could entail substantial costs. If the domestic financial system is relatively large and developed, a comprehensive regulatory and supervisory operation will be required anyway, and the extension of these activities to offshore banks will entail little in the way of extra cost. But for a small and unsophisticated local system, the extra cost may be quite large.

The major indirect cost attached to hosting offshore banks is a diminution in autonomy where domestic monetary policy is concerned, together with an increased potential for tax evasion and, possibly, deleterious competitive effects upon local banks. However, diminution of autonomy may not occur, since there may be little to lose.

If offshore banking is rigorously limited to accepting foreign currency funds from, and lending

them to, nonresidents, then ex definitio there should be no impact upon onshore financial flows. However, in most of the offshore centers, there has been some blurring of the lines between offshore and onshore activity; in particular, several centers have encouraged lending by offshore banks to specific projects—generally, although not always, to those involving the host country's government. In addition, it may not always be possible to regulate effectively the activities of the offshore institutions. If confidentiality of operations is guaranteed, it may be difficult, even for the regulators, to identify resident and nonresident transactions clearly, particularly in the absence of exchange controls.

Offshore business can also create fiscal problems. Hong Kong, for instance, has reportedly been reluctant to encourage this business because of the increased potential for Hong Kong residents to deposit funds with offshore institutions and then take dummy loans of the same amount. The interest from the loan would then be deductible for tax purposes, while the interest paid on the deposits would not be taxed.

Another possible cost of offshore banking could be the impact of increased competition on the domestic financial system. It is difficult for a broad-based financial system to develop in head-to-head competition with international banks. In particular, if the local monetary authority lacks the willingness or ability to act as a lender of last resort to the domestic banking system, the competitive advantage of the foreign banks, which are able to draw upon their head offices to augment their liquidity, may be so strong as to inhibit further development of indigenous banks. This problem could be avoided by forbidding offshore banks to operate domestically; but, if there are no onshore operations, indirect benefits may not accrue to the host country.

Offshore banks may also increase demand for office space, housing, and professional services; this may cause problems for local residents as the supply of such resources may not be flexible in the short run.

While the benefit-cost equation appears favorable for exist-

ing centers, it seems possible, indeed probable, that there is little unsatisfied demand for new offshore centers. There are even some signs at present of an excess supply. If one looks at the existing geographical coverage provided by offshore centers, virtually every area of the world has a selection of offshore centers readily accessible. In addition, improved telecommunications render it easier than before to route paper busi-

ness through a limited number of centers rather than setting up operations in several widely dispersed centers. In general, therefore, new paper centers are now likely to succeed. In addition, even existing centers might become less important and less profitable if moves to impose controls on the Eurocurrency markets are successful, and/or if New York establishes an International Banking Zone.

Handloom textiles.....

duction and 20 centres will be established in due course. The Department of Textiles expects to provide employment to 75 technicians at a centre. The buildings requirement for this purpose is to be met by obtaining and getting repaired unused buildings owned by other government departments. A provision of Rs. 4½ lakhs was made in the decentralised budget in 1979 to establish 40 machine centres. According to the textile department surveys a machine working in its full capacity could produce 1200 yards per year. Accordingly, it is expected to produce 4,156,800 yards by using 3,464 machines, in 1980 at these National Textile Centres. In addition to this, it is also expected to produce 6,466,560 yards of textile by the centres intended to be established in 1980.

This scheme is planned in such a way, as to ensure that a weaver depending on the handloom textile industry receives a minimum monthly income of Rs. 250/-. A weaver above average could earn about Rs. 300/-. These weavers would also get the training required, to join a factory in the private or a government sector free of charge.

Since competition could be anticipated in the open market it is essential to stabilise this industry. It is also essential to improve the quality and the designs of these textiles and to make them popular in the market. A new programme has been launched to improve the finish of these textiles and to distribute different designs, throughout the country. Hitherto there was only one such centre in the Island and the 2nd centre has been opened in the Kandy district in 1980. The Textile Department is working out plans to establish one such centre for every district.

An additional division is functioning to ensure that the objec-

tives of these service centres and National Textile centres are achieved and that the products are marketed. The ready made garments division should be improved and with state assistance orders from abroad have to be obtained. Action is being taken to market these textiles at the regional textile shops and also at the producing centre itself. Textile Exhibitions at district level would render a fruitful service. The mobile market system launched recently too could be a useful venture.

With a view to overcoming the marketing problems of the handloom weavers, which had been a major problem faced by the handloom industry, a marketing company under the name of "LANKA FABRICS LTD", has been established as a private company. All institutions coming under the Ministry of Textile Industries along with the Department of Small Industries, have been made shareholders of this company and are represented on the Board of Directors. Private sector expertise is being brought into the management of this company and the Chairman of the company is from the private sector. Action is also being taken to establish another private limited liability company which will adopt selected handloom centres specifically to produce items for export. This company will receive assistance from the IDA and the World Bank.

In any case, the Textiles Department has to make efforts to see that local textiles are produced to attract the customer and attractive designs are also used since it has to match the imported textiles. The success of this industry would depend on the extent the handloom textiles attract the customer.