

Offshore Finance Activities in Vanuatu: an Empirical Study of Determinants and Growth

T.K. Jayaraman

The Republic of Vanuatu, an archipelago of about 80 islands in the South Pacific, is located roughly 2,300 kilometres to the east of Australia (see Figure 6.1). Formerly known as the Anglo-French condominium of the New Hebrides, Vanuatu gained independence in 1980 and has come to be recognized for its wide range of services to offshore investors (Economist Intelligence Unit, 1987). The finance centre, comprising various types of offshore activities and supportive onshore institutions, was first established in 1971. Successive governments after independence continued their thrust on promotion of offshore finance centre (OFC) activities through provision of various incentives and enactment of legislative measures, including the latest International Companies Act, which was enacted in 1992.

Promotion of OFC activities and development of tourism, which have been described as the twin engines of growth for Vanuatu, have led to the creation of a dual economy. As a result, a modernized and sophisticated services sector, which is mainly confined to the capital city of Port Vila on the island of Efate, exists side by side with a subsistence-oriented primary sector, spread over the rest of the country's territory and scattered into various remote islands. The outer islands are engaged mainly in the production of root crops for self-consumption and in the secondary but declining export sector activities, including copra and cocoa, for which prospects are not bright in the near and medium terms. Partly because of this factor and partly because of the growing attractions of city life, there has been an exodus of rural youth to Port Vila in search of opportunities in the urban sector (Cole, 1993).

Tourism activities can be successfully dispersed and promoted in the outer islands by attracting the visitors to the location-specific natural scenic spots,

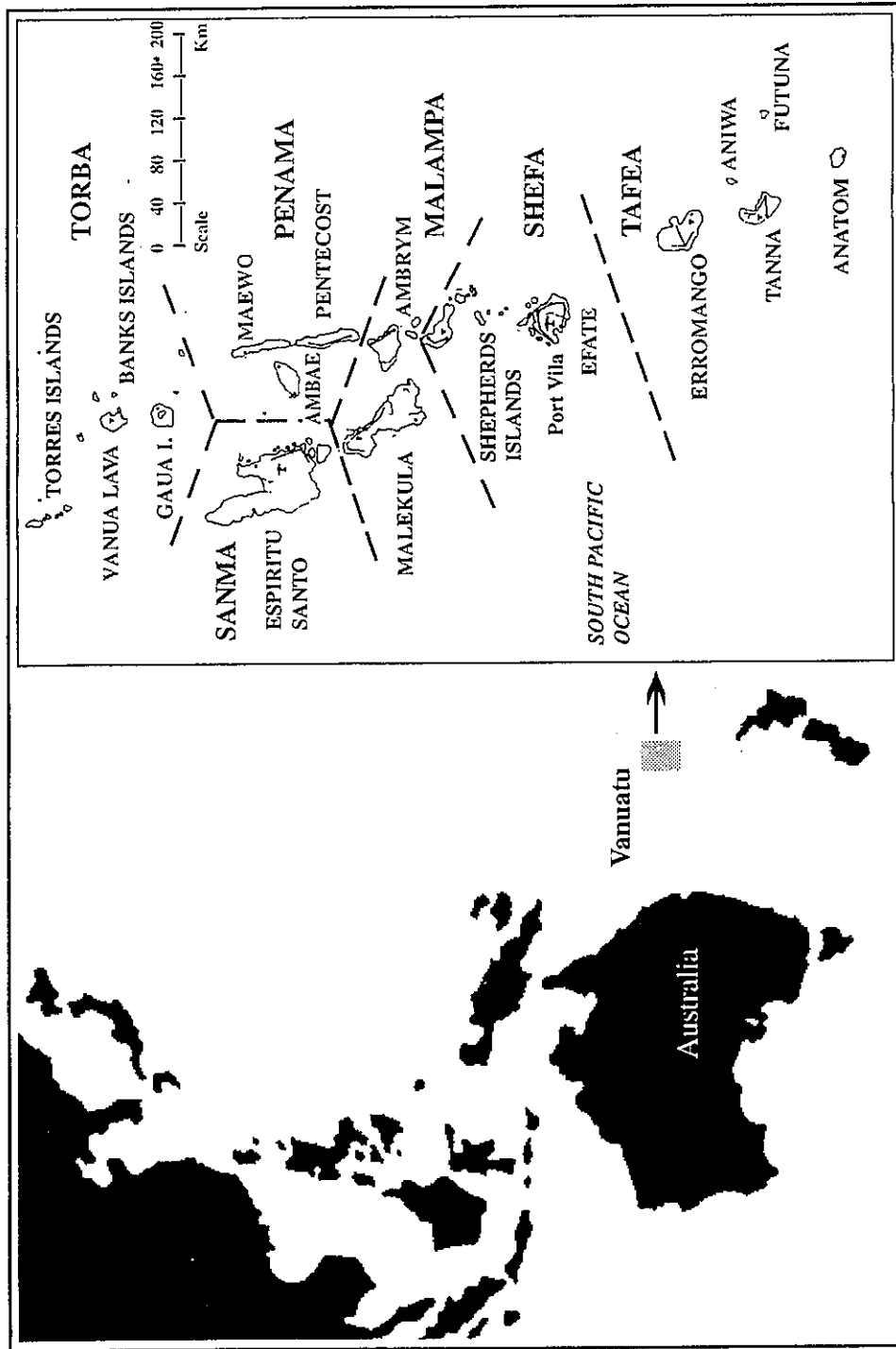


Figure 6.1 The Republic of Vanuatu and its location in the South Pacific Ocean

including live volcanoes, through provision of infrastructures including airstrips and incentives for construction of beach resorts, thereby striving towards balanced regional development to reduce rural-urban disparities (Jayaraman, 1993a). The OFC activities, on the other hand, cannot be so easily spread out as electronic communication facilities, and the pool of specialized services in skills including computer operations, accountancy, law and insurance, which are known as 'pin-strip infrastructures', are firmly urban-based. The question that could be legitimately raised concerns the nature of the impact of OFC on Vanuatu's economic growth and human resource development.

The objective of this chapter is to undertake an empirical study of the factors behind the growth of the OFC in Vanuatu and its contribution to and its impact on the economy. The chapter is organized into four sections: the first section deals with the government measures and growth trends in OFC activities; the second section analyses the factors behind the growth, by testing a simple model developed on the basis of observed practices in Vanuatu and elsewhere in the world, and presents the results of an empirical investigation; the third section evaluates benefits and costs of OFC; and the fourth and final section lists conclusions and recommendations.

Offshore Finance Centre Activities in Vanuatu

Conceptual issues

Offshore finance centres are of two kinds: notional and functional. The notional OFC is a 'paper' concept, which refers simply to loan booking activity, such as the one relating to Eurocurrency centres (McCarthy, 1979). In the 1970s, when Hong Kong residents had to face 15 per cent interest tax, Vanuatu emerged as a satellite centre for Hong Kong as a loan booking centre for the latter's residents desiring to avoid the tax (Johns, 1983) and was a paper OFC before graduating to full status. A functional OFC by definition, on the other hand, offers a full range of financial services, including international banking, offshore fund and trust management, legal services, insurance and a host of related services.

Another related issue is the difference between OFCs and tax havens. Tax havens and OFCs are not necessarily the same thing. Tax havens generally signify either the presence of low tax rates or the absence of any forms of direct taxation. Tax havens so defined, however, may not offer all types of OFC activities. Some tax havens may simply be paper or notional OFCs and continue to remain so without ever reaching the full status.

Tax haven status

Vanuatu has no individual income or corporate taxes and there is a complete absence of any withholding taxes, capital gains or gift taxes, estate duties or

death duties for both residents and non-residents. Further, the country has not signed any tax treaties with any country or jurisdiction. Therefore, the country qualifies to be a tax haven in the pure sense of the term. In addition, absence of exchange control with no restrictions on the movement of funds to or from any part of the world has enabled Vanuatu to earn the description 'a happy haven' (Economist Intelligence Unit, 1987).

Vanuatu thus presents 'zero friction' in terms of minimal banking regulations and taxes, and especially absence of direct taxation as against the prevalent 'international friction matrix' on onshore metropolitan countries in the region. The theoretical view is that funds flow from the onshore international friction matrix of bank regulations and taxes that distort the operations of free markets to zero friction (Johns, 1983). This view is confirmed by Walter (1985) and Naylor (1987). They also point out that onshore regulation and taxation would lead to increasing abuse of OFCs, resulting in illegal activities. The positive view, on the other hand, is that the offshore institutions have a proactive role in seeking deposits from the onshore sources.

Macro-economic stability

Vanuatu relies only upon indirect taxes and non-tax sources for raising revenues for meeting public-sector expenditures (Table 6.1). The governments since independence have adopted prudent fiscal and monetary policies and have successfully avoided budget deficits of a sizeable nature on the recurrent budget side (Jayaraman, 1993c). Its development expenditures are mostly financed by external aid, mainly in the form of grants from bilateral and multilateral donors, including the European Union, and loans from the multilateral lending agencies on concessional terms, while technical assistance, all in the form of grants from the donors, bilaterals and multilaterals alike, has been meeting the inadequacies in regard to expertise in various spheres, especially in the public sector. The situation in Vanuatu is not dissimilar to what is generally prevalent in the other island nations in the South Pacific (Jayaraman, 1995b). These policies as well as substantial official development assistance have contributed to relative price and exchange rate stability (Jayaraman, 1993c).

Legislative provisions

Additional facilities, where are generally offered by comparable OFCs elsewhere,¹ are available in Vanuatu. These mainly relate to (a) less complicated regulatory legislation; (b) inexpensive registration and other related operating expenses; (c) secrecy provisions; (d) variety of financial services; and (e) other attractive products. Vanuatu's legal system governing OFC activities consists of the Companies Act 1986 (Chapter 191), under which both local companies and companies exclusively for offshore operations, known as

Table 6.1 Key economic indicators for Vanuatu

Land area (sq. km)	12,000
Sea area (sq. km)	680
Population ('000)	150 ^a
Density per sq. km	13
Population growth rate (per cent)	2.9 ^b
Gross domestic product (US\$ million, 1991 prices)	177
Per capita Income (US\$)	1,180
GDP growth rate (%)	2.3 ^c
Inflation rate (%)	8.2 ^d
Foreign aid (% of GDP)	31.1 ^e
Public-sector investment (% of GDP)	16.5 ^f
Private-sector investment (% of GDP)	15 ^f
Total domestic debt (% of GDP)	31.5 ^f
External debt (% of GDP)	21.0 ^f
Debt services (% of exports)	2.0 ^f
Total government revenue (% of GDP)	23.5 ^g
Tax revenue (% of GDP)	18.3 ^g
Non-tax revenue (% of GDP)	5.2 ^g
Total government expenditure (% of GDP)	40.0 ^g
Recurrent expenditure (% of GDP)	21.8 ^g
Development expenditure	18.2 ^g
Overall budget balance (% of GDP)	-16.5 ^g
Recurrent budget balance (% of GDP)	1.7 ^g

Sources: World Bank (1991); Asian Development Bank, *Key Indicators of Asian and Pacific Developing countries*, various volumes

^a1990 estimate

^b1980-90

^c1981-90 annual average

^d1981-91 annual average

^eIncludes all forms of aid including overseas training

^f1982-91 annual average

^g1992

exempt companies, have been and can still be registered, and the more recent International Companies Act 1992 is for the specific purpose of facilitating easy registration of OFC companies. In addition, there are other relevant provisions governing OFCs. These are the Banking Act 1970 (Chapter 63), the Trust Companies Act 1971 (Chapter 69), the Insurance Act 1973 (Chapter 82) and the Stamp Duties Act 1970 (Chapter 68).

New International Companies Act 1992

Although any OFC entity, provided that it does not engage in local activities except in furtherance of its international operations, can still be registered under the old Companies Act, the new International Companies Act provides speedy registration procedures, eliminating some of the earlier requirements under the 1986 Companies Act. An exempt company registered under the 1992 Act does not have any annual reporting requirement, unlike in the past. The earlier requirement of one local resident director in Vanuatu has also been done away with. The new Act allows shares to be held

in bearer form offshore with only a nominee onshore, with a registered office and a local postal address.

Thus, the new legislation, which enables simple and speedy registration procedures, has considerably reduced the operating costs of an exempt entity registered under the Act. Further, all exempt companies registered under the 1992 Act have been given a guarantee of exemption from taxes of any kind for a 20-year period, except the stipulated annual registration fees. The exempt companies registered under the earlier 1986 Companies Act have been given an option to register themselves under the new legislation. The annual registration fees payable by the exempt entities and the annual fees for work permits for employment/business payable by the expatriate persons are shown in Table 6.2.

Secrecy provisions

The secrecy provisions that existed in the 1986 Companies Act have been further strengthened in the Act of 1992. International investors are immune from the disclosure of any dealings through Vanuatu. The government is also equally committed to its policy of not allowing any information on any transactions or dealings in Vanuatu to be disclosed. Heavy punishments, including fines and imprisonment, are liable to be imposed on those who

Table 6.2 Fees payable by financial sector institutions (in vatu)

<i>Categories</i>	<i>Groups</i>	<i>Annual registration fees</i>	<i>Business Licence Fees</i>
1. Commercial banks	A. Local	200,000	4 per cent turnover; minimum fee: 5 million
	B. Exempt	300,000	—
2. Legal and accounting firms		200,000	4 per cent turnover; minimum fee: 100,000
3. Trust companies and financial institutions	A. Local	200,000	2 per cent turnover; minimum fee: 300,000
	B. Exempt	200,000	—
4. Local insurance companies	A. Local	50,000	A. 1. Life insurance; 2 per cent turnover; minimum fee: 150,000 2. Other insurance; 2 per cent turnover; minimum fee: 300,000 3. All classes; 2 per cent turnover; minimum fee: 500,000
	B. Exempt	100,000	B. Brokers —

infringe the secrecy provisions. However, so far no one has been found guilty of any infringement of secrecy provisions.

Registration of OFC companies

Registration application may be made by nominee companies of the trust accountant, legal and corporate management firms located in Vanuatu. A large number of law partnerships also handle registration and offer legal services. New trust company legislation has been planned in order to strengthen the existing body of law, while retaining the familiar concepts of British trust law and asset protection. A new Company Managers Act is also under preparation so as to give greater regulatory powers to the government to ensure standards of professionalism.

Banking sector

The banking sector, comprising three commercial banks and one fully owned government bank, provides a full range of banking services to enable the exempt companies and investors to move funds into and out of the country. The offshore exempt banks, which are registered and licensed under the Companies Act and the Banking Act, cannot do business in the country, like other exempt companies. However, all these exempt companies and institutions use the banking sector of the country for moving their funds into and out of the country. Absence of exchange control and freedom for both residents and non-residents alike to hold deposits in any currency, either domestic or foreign, have contributed to the emergence of a sophisticated banking system (Jayaraman, 1993b).

Other products

Personal trusts can be set up in Vanuatu against perpetuities. The settlor of a Vanuatu trust can be resident anywhere and does not have to stay in Vanuatu, and the trust property need not be located in Vanuatu either. However, the credibility of Vanuatu trust *vis-à-vis* foreign authorities is enhanced if a local bank or a trust company is appointed as a trustee.

Vanuatu's tax haven status, with its less complicated and less expensive registration procedures, has also encouraged insurance companies to establish themselves as offshore exempt companies. The offshore insurance companies established in Vanuatu undertake captive insurance operations whereby insurance risks in a group are put through the exempt insurance company, which then reinsures through third-party underwriters. The favourable results are reduced premiums and underwriting risks as well as maximum tax deductions across various jurisdictions. The exempted insurance companies so registered in Vanuatu do not have to comply with the financial and reporting requirements which are applicable to insurance companies operating locally.

Ship registration

Another product of Vanuatu's OFC is shipping registration through the Republic of Vanuatu Ship Registry, which offers the full advantages of the International Ship Registry System. It is regulated by legislation introduced in 1981, and the registration service is headed by a commissioner for maritime affairs. A second registration office operates out of New York to make it easier for western-hemisphere shipowners to fly the Vanuatu flag. The initial registration fee for varying tonnages (payable once only), annual tonnage fees and survey tax and other fees charged by Vanuatu are highly competitive and are reported to be much lower than the corresponding fees charged by Panama or Liberia for flying their flags.

Table 6.3 presents data on companies on the live register as of 31 December of each year for the period 1979-93. The data relating to exempt companies are categorized only into three kinds: exempt banks, exempt financial institutions and others. The others include a host of entities including individual trusts and captive insurance companies. Given the limitations in availability of data, it is apparent that the number of total exempt companies of all categories went up from 505 in 1980 to 1,018 in 1992, an increase of 100 per cent. The number, however, decreased in 1993 to 905, possibly reflecting the then prevailing level of investor confidence.

The number of exempt banks increased threefold during the corresponding period, from 41 in 1980 to 120 in 1993. The number of exempt financial institutions, on the other hand, remained steady at 6. The trust companies,

Table 6.3 Companies on the register (as of 31 December each year)

Year	Local companies	Overseas companies		Exempt companies			Total
		Trust companies	Total overseas companies	Exempt banks	Exempt financial institutions	Total exempt companies	
1979	276	12	35	35	5	473	784
1980	291	12	36	41	5	505	832
1981	341	12	34	56	5	555	930
1982	384	13	34	68	5	584	1,002
1983	372	16	36	72	5	516	924
1984	405	15	34	85	7	600	1,039
1985	423	15	40	93	5	644	1,107
1986	403	10	36	93	5	666	1,105
1987	497	12	36	93	6	711	1,244
1988	633	12	37	97	6	736	1,406
1989	812	12	33	103	2	834	1,679
1990	871	12	37	103	6	932	1,840
1991	926	12	37	105	6	890	1,853
1992	1,036	12	40	114	6	1018	2,094
1993	1,123	12	44	120	6	905	2,072

Source: Reserve Bank of Vanuatu: *Quarterly Economic Review*, various issues

which assist the exempt companies in their formation and incorporation, by extending advisory services in legal and tax matters, fluctuated in number from 12 to 16 in the initial years of the period under consideration and in the later years remained steady at 12.

Determinants of Growth of the Offshore Finance Centre

Supply factors

Studies of OFCs have identified certain factors which appear to have contributed to the success of well-known OFCs in the world, such as the Bahamas and Channel Islands. There are (a) tax haven status; (b) commitment to secrecy; (c) an open economy; (d) political stability; (e) a well-developed communications system; and (f) advantages of location and convenience of time zone (International Monetary Fund, 1982). While such a broad generalization may be helpful, certain location-specific characteristics that obtained in the case of Vanuatu, and that cannot be easily replicated elsewhere, deserve mention. These can be broadly categorized into internal and external factors. Internal factors include historic specificity, government initiatives, tourism development, financial infrastructure and the local population's knowledge of English and French.

Historic specificity

Although Vanuatu shared its colonial heritage with other South Pacific island nations before their independence, direct taxation was never introduced during the colonial days. The same policy continued after independence in 1980. Additionally, OFC activities were encouraged by the colonial rulers themselves as early as 1971. This encouragement to Vanuatu to emerge as an OFC is similar to help given by Britain and the Netherlands in regard to OFCs of various Caribbean islands, including the British Virgin Islands, the Cayman Islands, and Montserrat and the Turks and Caicos Islands.²

Government initiatives

Government initiatives have been consistently in the direction of moving forward with OFCs. The Minister of Finance made a forthright announcement in the Parliament in December 1993 ruling out any idea of consideration of any form of direct taxation. Further, as noted before, a guarantee of exemption for 20 years has been provided under the International Companies Act of 1992 for all OFC entities registered under the Act. In addition to being a liberal, open economy, Vanuatu has no exchange controls and there are strict secrecy provisions, ensuring confidentiality of all operations by exempt companies. These measures and the planned legislative steps have

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made clear the government's intention to portray Vanuatu as a place of 'zero friction' in the international friction matrix for attracting financial capital.

Tourism development

The government has been promoting tourism as one of the two engines of growth, the other being OFC. Tourism promotion activities have contributed to the creation of infrastructure in terms of airport development, hotels, resort facilities and many leisure activities, including golf courses and casinos, besides providing support to the national airline so that it can bring in more tourists. All these efforts have popularized Vanuatu among retirees and others seeking places to spend their leisure time, thus attracting tourists and investors alike.

Tourists who visit by air or cruise ships on short day trips learn about OFC activities and related advantages and are encouraged to use the facilities. Retirees, especially high net worth individuals (HNWIs), who visit Vanuatu initially as tourists are encouraged to put their savings in Vanuatu trusts and derive tax advantages. Similarly, pure investors who come for business are attracted by tourist developments and may decide to spend an extended holiday, and even come later as pure tourists. Thus, tourism and OFC seem to be supporting each other. A 'symbiotic relationship suggested by an interrelation of the two industries', as is witnessed in the Caribbean and Channel Islands (Casanegra de Jantscher 1976; Hampton, 1994b), appears to be operative in Vanuatu.

Financial structure

An open economy with absence of exchange control on the movement of capital into and from the country has contributed to the emergence of a sophisticated financial structure. The HNWIs, besides OFCs, have provided a booming demand for private banking and other services.

Knowledge of English and French

Although university and high school graduates as well as technically qualified persons are in short supply, the relatively high literacy rate has provided the country with a labour force able to speak either English or French. Long traditions of an open-door policy to foreigners who wish to work and reside in Vanuatu have contributed to the emergence of a cosmopolitan culture conducive to acceptance and development of OFC activities which are dominated by expatriates. These expatriates supply the critically required skills in computer operations, law and accountancy, which fall under the description of 'pin-stripe infrastructure'.

Demand factors

Demand factors behind the growth of OFC institutions are (a) actions of the metropolitan powers in the region; (b) impact of international events; (c) competition from other OFCs in the region; (d) demand-driven preferences; (e) the time zone; and (f) technological trends.

Actions of metropolitan governments

The history behind the emergence of tax havens shows that it was the existence of certain features in the tax systems of developed countries that allowed taxpayers to take advantage of the benefits offered by tax haven countries. These included more favourable treatment to trusts located abroad than to domestic trusts and the mechanism of tax deferral that allowed taxpayers of high-tax countries to defer income tax payments on income from foreign sources until it was repatriated. These and other escape valves left in their tax systems by high-tax countries encouraged small-resource-based island and other micro-states to create zero friction for attracting funds from these countries (Casanegra de Jantscher, 1976).

However, in recent years, realizing that not all the blame can be placed on tax havens for the losses of tax revenue they suffered, the developed countries have passed several anti-tax avoidance laws. These measures have reduced the tax havens' attractions and made life for tax haven governments not 'all sweetness and light' (*The Economist* Publications, 1990, p. 90). In regard to Vanuatu and other island nations in the south Pacific, Australia and New Zealand have been watchful on tax evaders and have passed far-reaching anti-avoidance legislation (*The Economist* Publications, 1990, p. 98). However, there have been exceptions, as noted in the case of Jersey's growth as an attractive OFC.³

Impact of international events

World events of an adverse nature in recent years have apparently helped Vanuatu's OFC institutions to flourish. During the Gulf War, capital flight from politically unstable areas in the Middle East to other, safer havens, including Vanuatu, took place. Similarly, there has been a noticeable capital flight from Hong Kong to many other safer havens as 1997 approached. Since secrecy provisions do not permit any disclosures, it can be surmised that Vanuatu, with its known political and economic stability, will have been one of the main beneficiaries among many safe havens. From the published revenue figures of the government, during the Panama crisis in 1990, the ship registration figures made a quantum jump and revenues soared, as ships preferred to fly the Vanuatu flag (Table 6.4). It is thus obvious that crises elsewhere in the world should result in gains for Vanuatu.

Table 6.4 Shipping registration (as of 31 December each year)

Year	Ships registered	Shipping fees collected (Vt million)
1981	1	n.a.
1982	4	1.0
1983	25	5.0
1984	46	12.0
1985	65	18.5
1986	93	29.1
1987	150	32.3
1988	198	33.1
1989	310	63.0
1990	357	119.0
1991	401	46.2
1992	380	44.0
1993	385	50.0

Source: Reserve Bank of Vanuatu, *Quarterly Economic Review*, various issues.

Competition from other OFCs

Competition from the other South Pacific OFCs including those of Cook Islands, the Solomon Islands, Tonga and Western Samoa has been less than intense for many reasons. Chief among them is that none of the countries can match Vanuatu's total absence of direct taxation. Second, the vigorous campaign and support for OFCs in combination with promotion of tourism have been a unique feature of Vanuatu, one not paralleled anywhere in the region. Above all, Vanuatu's OFC has so far been free from any damage to its reputation caused by questionable deals of the kind witnessed in regard to the Cook Islands' OFC, as reported in the press (*Islands Business Pacific*, 1994).

Demand-driven preferences

In addition to those investors in Hong Kong and Taiwan who, in the midst of uncertainties, perceive Vanuatu as a safe haven, a large number of retirees and leisure-seeking active business people from other parts of the world, including Australia, find Vanuatu a peaceful and scenic place for spending the rest of their lives and enjoying holidays. As a result, many of them have been moving their funds to Vanuatu.

Time zone

As Vanuatu OFC operates just three hours ahead of the South Asian markets, investors from South-East Asia, especially Taiwan and Hong Kong, find it convenient to deal with Vanuatu.

Technological trends

Improvements introduced in telecommunications, through satellites and electronic mail, have eliminated the need for services to be physically close. Vanuatu's telecommunications system is operated by a joint venture between two well-known multinational private-sector companies and the government. Substantial investment has been undertaken to provide international links on a 24-hour basis using digital technology.

A model for empirical investigation

Although most of the factors described above are of a general, descriptive nature, certain factors can be quantified and testable hypotheses can be formulated. However, construction of a model for undertaking an empirical analysis is severely constrained by the inadequate nature of the data. For example, national income data for Vanuatu are available only from 1983 to 1990, and the data on OFCs, as far as they relate to value-added activities in terms of salaries and wages and profits in non-secret operations, have been compiled purely on a voluntary basis and they cover the period 1981-93.⁴ Since the number of observations is constrained by the limited time-series data, the degrees of freedom are insufficient for a robust statistical analysis. In the context of these highly restrictive conditions, an empirical analysis has been attempted with a caveat that the results obtained should be viewed with due caution.

Testable hypotheses

On the basis of the theory of 'zero friction', one can hypothesize that global funds generally flow to the OFC of a country whose revenue-raising efforts, as signified by the ratio of total revenue (taxes and non-taxes, including fees and user charges) to gross domestic product (GDP), are relatively less than those of 'higher-friction states'. In other words, the lower the revenue-mobilizing efforts of a tax haven, the greater would be the number of OFC institutions attracted to the country and their contribution to GDP. However, there is an opposite point of view that OFC activities are less sensitive to local taxes and levies as they generate profits in their own right rather than solely via the avoidance of taxes and levies elsewhere (McCarthy, 1979), and therefore there may not be any significant association between local resource-mobilizing effort in a given tax haven which attracts OFC institutions and their operations. Given this viewpoint, the testable hypothesis is that the contribution of OFC activities scaled by GDP, represented by the term *ofc*, which is the ratio of OFC's contribution to GDP, is negatively related to the ratio of total revenue to GDP, which is represented by the term *tr*.

On the other hand, it is claimed by tax haven countries that the revenues 'hypothetically forgone', through either low tax rates or absence of direct

taxation, are more than compensated for by revenues generated through licence and registration fees levied on OFC institutions. The emerging hypothesis from this stand is that tr is positively associated with ofc . Thus, there appears to be a two-way association in the relationship between ofc and tr , involving some degree of simultaneity between the two variables, although the nature of direction, either positive or negative, remains to be tested. However, in tax havens with no direct taxation of any kind, whether on their citizens, on corporate bodies, on resident expatriates or on OFC institutions, government revenues are mostly realized from taxes on consumption, with substantial incidence on international trade, since most of the imports are associated with expatriates' consumption. Thus, the ratio of tax revenue to GDP is positively associated with ratio of imports to GDP.

As OFCs' institutions are generally encouraged by tourism development, one can postulate that tourism promotion expenditures by the public sector through campaigns and publicity measures directly influence OFCs' contribution to GDP. It can also be hypothesized that OFC activities are positively associated with political stability, signifying greater flow of funds during periods of peace and order. Similarly, economic stability, represented by a low rate of inflation, and presumably the result of prudent fiscal and monetary policies (Blazic-Metzner and Hughes, 1982), would directly influence the entry of offshore institutions and encourage OFC activities.

A simultaneous equation system model

Based on the above, the proposed model is one of a simultaneous equation system with two endogenous variables (ofc and tr) and four predetermined variables (ratio of tourism promotion expenditures to GDP, ratio of imports to GDP, rate of inflation as a proxy for economic stability and a dummy variable for political stability) and a lagged variable (tr lagged by 1 year).

$$ofc = f(tr, tpe, D, inf) \quad (6.1)$$

$$tr = f(ofc, tr_{-1}, m) \quad (6.2)$$

where ofc is the ratio of the OFC's contribution to GDP; tr is the ratio of total government revenue to GDP; tpe is the ratio of tourism promotion expenditure to GDP; m is the ratio of imports to GDP; inf is the rate of inflation; and D is a dummy variable for political stability, assuming a value of unity during years of stability and zero during years of instability.

Estimated equations

The first equation is exactly identified and the second one is over-identified. Therefore, the estimation had to be performed through a two-stage least squares method. The data employed covering a seven-year period for fitting

Table 6.5 Variables employed in regression analysis

Year	OFC's contribution (% of GDP)	Government total revenue (% of GDP)	Tourism promotion expenditure (% of GDP)	Imports (% of GDP)	Rate of inflation (per cent)
1984	6.23	20.3	0.04	55.20	5.4
1985	8.19	23.7	0.06	58.60	-0.1
1986	11.77	24.4	0.18	50.13	-0.07
1987	7.08	26.1	0.19	56.98	8.8
1988	9.72	26.0	0.31	49.55	10.1
1989	9.64	25.6	0.24	50.02	4.5
1990	9.74	24.1	0.23	62.63	4.3

Source: Statistics Department, Government of Vanuatu, and author's calculations

the equations are given in Table 6.5. Both linear and log-linear formulations were attempted. The log-linear equations emerged as better fits in terms of higher *R* square duly adjusted for degrees of freedom. The results of log-linear equations are reported here, and are as follows:

$$\ln ofc = 2.703 - 1.005 \ln tr + 0.412 \ln tpe^* + 0.069D^{**} - 0.014\ln i^{*} \quad (6.3)$$

(2.817) (-1.533) (5.112) (2.815) (-3.898)

$$\text{adj } R \text{ sq} = 0.919 \quad D \text{ W Stat} = 2.984 \quad F \text{ ratio} = 18.190$$

$$\ln tr = -0.377 + 0.048 \ln ofc + 0.724 \ln tr_{-1}^* + 0.422 \ln m^* \quad (6.4)$$

(3.17) (-1.312) (0.607) (6.306)

$$\text{adj } R \text{ sq} = 0.921 \quad D \text{ W Stat} = 2.092 \quad F \text{ ratio} = 24.247$$

(The figures in parentheses denote calculated *t* values.)

* significant at 5 per cent level

** significant at 10 per cent level

In the estimated equation with $\ln ofc$ as dependent variable, the sign of the estimated coefficient of $\ln tr$ was negative, indicating a theoretically expected inverse relationship of lower revenue to GDP ratio and higher contribution of OFC to GDP. However, the estimated coefficient was found to be statistically not significant.

The parametric coefficients of other explanatory variables too emerged with the theoretically expected signs. The predetermined explanatory variable *tpe*, representing the ratio of tourism promotion expenditure to GDP, is observed to have a positive association with the dependent variable *ofc*. On the other hand, inflation, which is a proxy variable for economic stability, is inversely related to *ofc*, indicating that a low rate of inflation, representing greater economic stability, attracts OFC activities. These two estimated

parametric coefficients were also found to be statistically significant at the 5 per cent level. The dummy variable representing political stability also emerged with statistical significance, although at the 10 per cent level.

In regard to the equation with $\ln tr$ as dependent variable, the sign of the estimated coefficient of $\ln ofc$ was found to be in accordance with theoretical expectations. However, the estimated coefficient was found to be statistically not significant. On the other hand, the estimated coefficients of the two predetermined variables, namely lagged $\ln tr$ and $\ln m$, turned out to have the appropriate signs and were found statistically significant at the 5 per cent level.

A single equation model

Since the two-way relationship between ofc and tr was found to be statistically not significant, a single-equation model with ofc as dependent variable was considered more appropriate. Accordingly, the regression equation was estimated by an ordinary least squares (OLS) method, retaining all the four explanatory variables, including tr . Again the log-linear equation emerged as a better fit in terms of higher R square, duly adjusted for degrees of freedom.

The estimated equation is:

$$\ln ofc = 2.164 - 0.636 \ln tr + 0.376 \ln tpe^* + 0.064D^* - 0.015\ln f^* \quad (6.5)$$

(2.870) (-1.235) (5.643) (2.956) (-4.529)

$$\text{adj } R \text{ sq} = 0.936 \quad \text{DW Stat} = 2.499 \quad F \text{ ratio} = 22.985$$

As observed before, despite its theoretically expected negative sign, the estimated coefficient of tr was found to be statistically not significant. The statistical non-significance of relationship between ofc and tr indicates that the view taken by McCarthy (1979) that OFC activities are not sensitive to local taxes and levies as they generate profits in their own right cannot be rejected. Perhaps for this reason, it appears that some of the tax havens have been able to impose profit taxes on offshore banks.

Since the variable tr was found not to be significantly associated with ofc , it was dropped from the estimation procedure and a new equation, retaining all the other independent variables, was fitted by the OLS method. The fitted equation is:

$$\ln ofc = 1.235 + 0.314 \ln tpe^* + 0.054D^* - 0.016\ln f^* \quad (21.189)$$

(2.481) (6.592) (3.026) (-4.478) (6.6)

$$\text{Adj } R \text{ sq} = 0.925 \quad \text{DW Stat} = 2.071 \quad F \text{ ratio} = 25.636$$

The estimated equation was found very satisfactory in terms of both high adjusted R square and F ratio. Further, all the three independent explanatory

variables, namely the ratio of tourism promotion expenditure, rate of inflation proxy for macro-economic stability (the lower the rate, higher the degree of economic stability) and the dummy variable representing political stability), not only emerged with the theoretically expected signs but were also found to be statistically significant at the 5 per cent level.

Interpretation of results

Empirical investigation reveals the following: (a) there is no significant association between the contribution of OFC activities to GDP and low-revenue efforts, ruling out any sensitivity of local taxes and levies on OFC activities; (b) there appears to be a confirmed positive relationship between tourism and contribution of OFC activities to GDP, since tourism promotion efforts directly influence OFC activities; (c) political stability significantly influences OFC activities in a positive manner; and (d) inflation has a significant negative impact on OFC activities' contribution to GDP, which means that macro-economic stability is necessary for attracting OFC institutions.

Impact of OFC Activities on the Economy

The impact of OFC activities on the economy of Vanuatu can be categorized into benefits and costs, each of which will be of two kinds, direct and indirect. Generally, direct benefits render themselves into measurable magnitudes. However, since it is difficult to quantify indirect benefits as well as direct and indirect costs, only a qualitative description is attempted in this chapter.

Direct benefits

The main direct benefits of OFC activities are the local expenditures, comprising operating or recurring expenditures of salaries, wages, rent and interest payments, taxes and levies, and capital expenditures. Table 6.6 provides details of various categories of expenditures in current prices. The salary and wages component has two categories: (a) salaries paid to expatriates employed in the offshore institutions; and (b) wages and salaries paid to the local (known as ni-Vanuatu) citizens employed in these institutions.

Expenditure on salaries paid to expatriates has been around 60 per cent of total salary and wage bill (Table 6.7). More recently this proportion increased to 65.8 per cent in 1992 and 71.8 per cent in 1993. On the other hand, the local employees, who received 37.8 per cent of the total wages and salaries bill in 1985, have been getting less in recent years, although their share was about 45 per cent in 1991. However, then the proportion fell to 34.2 per cent in 1992 and 28.2 per cent of total wages and salaries in 1993. However, it will be of interest to note that the proportion of expatriate employees out of the total number employed by OFC institutions decreased over a nine-year period from 28.5 per cent in 1985 to 15.6 per cent in 1993. It is apparent that the

Table 6.6 Local expenditure of OFC institutions (million Vatu)

	1985				1986			
	Banks	Trust companies	Accounting and legal firms	Offshore companies	Total	Banks	Trust companies	Accounting and legal firms
Total local expenditure	508	157	263	165	1,093	478	169	280
1. Taxes and levies	15	18	21	65	119	26	20	26
(a) Central government fees	12	16	18	65	111	22	18	24
(b) Import duties	2	1	2	n.a.	5	1	1	1
(c) Local government fees	1	1	1	n.a.	3	3	1	1
2. Other recurrent expenditures	465	127	211	100	903	434	139	227
(a) Total wages and salaries	251	68	119	n.a.	438	269	80	135
(i) Ni-Vanuatu wages and salaries		n.a.	n.a.	n.a.	157	139	34	30
(b) Rent	11	5	14	n.a.	30	38	4	18
(c) Interest	1	n.a.	5	n.a.	6	6	n.a.	9
3. Capital expenditure	28	12	30	n.a.	70	18	10	27
	1987				1988			
	Banks	Trust companies	Accounting and legal firms	Offshore companies	Total	Banks	Trust companies	Accounting and legal firms
Total expenditure	691	209	269	201	1,370	855	198	291
1. Taxes and levies	21	14	31	94	160	39	6	18
(a) Central government fees	17	8	31	94	150	35	5	18
(b) Import duties	1	4	n.a.	n.a.	5	2	n.a.	n.a.
(c) Local government fees	3	2	n.a.	n.a.	5	2	1	n.a.
2. Other recurrent expenditure	594	170	227	107	1,098	752	174	251
(a) Total wages and salaries	345	89	132	n.a.	566	382	104	154
(i) Ni-Vanuatu wages and salaries	129	36	35	n.a.	200	182	37	39
(b) Rent	54	8	18	n.a.	80	53	5	29
(c) Interest	5	1	9	n.a.	15	n.a.	1	11
3. Capital expenditure	76	25	11	n.a.	112	64	18	22

(c) Interest	5	1	9	n.a.	15	n.a.	1	11	n.a.	12
3. Capital expenditure	76	25	11	n.a.	112	64	18	22	n.a.	104

	1989					1990				
	Banks	Trust companies	Accounting and legal firms	Offshore companies	Total	Banks	Trust companies	Accounting and legal firms	Offshore companies	Total
Total expenditure	1,102	240	303	255	1,900	870	313	383	489	2,055
1. Taxes and levies	20	6	20	133	179	38	10	30	325	403
(a) Central government fees	16	6	19	133	174	31	10	27	325	393
(b) Import duties	3	n.a.	1	n.a.	4	4	n.a.	1	n.a.	5
(c) Local government fees	1	n.a.	n.a.	n.a.	1	3	n.a.	2	n.a.	5
2. Other recurrent expenditures	973	227	261	122	1,583	768	240	339	164	1,511
(a) Total wages and salaries	309	110	178	n.a.	597	366	92	181	n.a.	639
(i) Ni-Vanuatu wages and salaries	146	55	45	n.a.	246	148	40	49	n.a.	237
(b) Rent	57	7	23	n.a.	87	73	2	22	n.a.	97
(c) Interest	n.a.	3	14	n.a.	17	n.a.	6	14	n.a.	20
3. Capital expenditure	109	7	22	n.a.	138	64	63	15	n.a.	142

	1991					1992				
	Banks	Trust companies	Accounting and legal firms	Offshore companies	Total	Banks	Trust companies	Accounting and legal firms	Offshore companies	Total
Total local expenditure	868	273	409	648	2,198	1,644	310	390	761	3,105
1. Taxes and levies	52	12	20	559	643	91	11	9	565	676
(a) Central government fees	33	10	16	559	618	73	10	11	559	653
(b) Import duties	4	0	1	n.a.	5	3	0	0	0	3
(c) Local government fees	14	2	3	n.a.	19	15	1	0	0	16
2. Other recurrent expenditures	778	242	365	88	1,473	1,505	276	363	187	2,331
(a) Total wages and salaries	382	111	197	n.a.	690	686	122	184	85	1,077
(i) Ni-Vanuatu wages and salaries	208	44	57	n.a.	309	194	86	46	43	369
(b) Rent	95	4	27	n.a.	126	161	11	28	3	203
(c) Interest	0	10	17	n.a.	27	—	12	12	3	27
Capital expenditure	37	18	23	n.a.	78	48	23	18	8	97

Table 6.6 *cont'd*

	1993				
	Banks	Trust companies	Accounting and legal firms	Offshore companies	Total
Total local expenditure	1,591	280	329	687	2,887
1. Taxes and levies	82	11	11	467	571
(a) Central government fees	62	11	8	467	548
(b) Import duties	3	0	0	0	3
(c) Local government fees	16	0	3	0	19
2. Other recurrent expenditures	1,462	249	311	211	2,233
(a) Total wages and salaries	713	133	193	92	1,131
(i) Ni-Vanuatu wages and Salaries	207	30	38	44	319
(b) Rent	169	6	31	4	210
(c)	—	8	14	3	25
3. Capital expenditure	47	20	7	9	83

Source: Reserve Bank of Vanuatu, *Quarterly Economic Review*, various issues

Note: n.a. = not available

Table 6.7 Employment statistics for OFC institutions

Year	Employment (number)			Wages and salaries (million vatu)		
	Expatriates	Ni-Vanuatu citizens	Total	Expatriates	Ni-Vanuatu citizens	Total
1985	104 (28.5)	261 (71.5)	365	258 (62.2)	157 (37.8)	415
1986	98 (26.5)	272 (73.5)	370	281 (58.1)	203 (41.9)	484
1987	89 (24.3)	277 (75.7)	366	366 (64.7)	200 (35.3)	566
1988	82 (21.1)	307 (78.9)	389	382 (59.7)	258 (40.3)	640
1989	75 (18.8)	323 (81.2)	398	352 (58.9)	246 (41.1)	598
1990	80 (20.4)	313 (79.6)	393	402 (62.9)	237 (37.1)	639
1991	86 (21.7)	311 (78.3)	397	381 (55.2)	309 (44.8)	690
1992	70 (16.2)	362 (83.8)	432	709 (65.8)	368 (34.2)	1,077
1992	68 (15.6)	368 (84.4)	436	812 (71.8)	319 (28.2)	1,131

Source: Author's calculations; Reserve Bank of Vanuatu, *Quarterly Economic Review*, various issues

Note: Figures in parentheses denote % of total

remuneration package per expatriate employee improved over the period. Correspondingly, the proportion of ni-Vanuatu employees went up from 71.5 per cent in 1985 to 84.4 per cent in 1993.

Although the proportion of salaries paid to expatriates to the total expenditure is sizeable and is classed as local expenditures, it is likely that major parts of the expatriates' incomes are spent on imported consumer goods, and savings are sent home for meeting their overseas consumption needs, including education of children. As a result, net benefits to Vanuatu's local economy from the resident expatriate salaries in terms of backward and forward linkages are likely to be less than would otherwise be the case.

In terms of proportion of GDP, total wages and salaries received by employees in OFC institutions rose from 3.3 per cent in 1985 to 5.1 per cent in 1992 (Table 6.8). Wages and salaries received by ni-Vanuatu employees varied between 1.3 per cent of GDP in 1985 and 1.7 per cent of GDP in 1992.

Taxes and levies

Total recurrent expenditures, besides salaries and wages, include taxes on imports and levies, including registration fees and business licence charges and stamp duties paid to the government and local government councils. The amount paid by OFC institutions in terms of taxes and levies in current prices

Table 6.8 Local expenditure of OFC institutions (% of GDP)

Year	Recurrent expenditure				Capital expenditure	Total local expenditure
	Total wages and salaries	Ni-Vanuatu salaries and wages	Taxes and levies	Total recurrent expenditure		
1985	3.3	1.3	0.9	8.2	0.5	8.7
1986	4.0	1.7	1.3	8.8	0.4	9.2
1987	4.2	1.5	1.2	9.4	0.8	10.2
1988	4.3	1.7	1.2	9.9	0.7	10.6
1989	3.6	1.5	1.1	10.8	0.8	11.6
1990	3.6	1.3	2.2	10.6	0.9	11.5
1991 ^a	3.5	1.6	3.3	10.7	0.4	11.1
1992 ^b	5.1	1.7	3.2	9.5	0.4	9.9

^aEstimates based on provisional GDP figures

increased nearly fivefold from Vt 119 million in 1985 to Vt 571 million in 1993. In constant 1990 prices, it went up from Vt 172 million in 1985 to VT 488 million in 1993 (Table 6.9). As a percentage of GDP, revenue derived from taxes and levies charged and collected from OFC institutions constituted about 0.9 per cent in 1985 and 3.2 per cent in 1993. In terms of contribution to total revenues collected by government, revenues from taxes and levies on OFC institutions were well above 10 per cent during 1991–93, having risen from a small proportion of 4.0 per cent in 1985 to the highest proportion of 13.6 per cent in 1991 (Table 6.10). There has been a decline since then, as the corresponding proportions were 13.4 per cent of GDP in 1992 and 11.2 per cent of GDP in 1993.

Table 6.9 Local expenditure for OFC institutions, 1984–93 (Vt million, at constant 1990 prices)

Year	Wages, salaries, rent and interest	Taxes and levies	Capital expenditure	Total local expenditure
1984	1,282 (84.3)	158 (10.4)	81 (5.3)	1,521
1985	1,294 (82.6)	172 (11.0)	100 (6.4)	1,567
1986	1,233 (80.4)	225 (14.7)	75 (4.9)	1,533
1987	1,334 (80.1)	194 (11.7)	136 (8.2)	1,665
1988	1,464 (82.3)	198 (11.4)	116 (6.5)	1,778
1989	1,639 (83.3)	185 (9.4)	143 (7.3)	1,967
1990	1,494 (73.5)	399 (19.6)	140 (6.9)	2,033
1991	1,425 (67.6)	597 (28.3)	86 (4.1)	2,108
1992	2,076 (75.1)	603 (21.8)	87 (3.1)	2,765
1993	1,910 (77.3)	488 (19.8)	72 (2.9)	2,470

Note: Figures in parentheses denote percentages of the total

Total local expenditures

Total local expenditures of OFC institutions in current prices increased nearly threefold during the ten years from 1984 to 1993. Inflation had its own

Table 6.10 Government revenues and taxes and levies paid by OFC institutions, 1985-93 (Vt million)

Year	Tax	Non-tax	Total	Taxes and levies paid by OFC institutions	Taxes and levies paid by OFC institutions (% of total revenue)
1985	2,298	672	2,970	119	4.0
1986	2,310	667	2,977	157	5.3
1987	2,875	624	3,499	160	4.6
1988	3,149	757	3,906	178	4.6
1989	3,380	756	4,166	179	4.3
1990	3,991	944	4,935	403	8.2
1991	3,574	1,136	4,710	643	13.6
1992	3,820	1,234	5,034	677	13.4
1993	3,800	1,273	5,073	570	11.2

Source: Reserve Bank of Vanuatu, *Quarterly Economic Review*, various issues

impact, and taking into account its effect, the local expenditures in constant prices show about a 130 per cent rise over the ten-year period (Table 6.9). In terms of percentages of GDP, local expenditures were 8.7 per cent in 1985 and rose to 14.7 per cent of GDP in 1992.

The major components of local expenditures of OFC institutions are wages, salaries, rent and interest payments. It is of interest to note that there was a declining trend in the ratio of this component to total local expenditures. The ratio was 84.3 per cent in 1984 and it was around 73 per cent on average during 1991-93. On the other hand, the ratio of expenditure on taxes and levies to total local expenditures recorded increases over the ten-year period. From about 10.4 per cent of total local expenditures in 1984, it reached a peak proportion of 28.3 per cent in 1991 and decreased to 21.8 per cent in 1992 and 19.8 per cent in 1993.

Comparison with other OFCs

The available data for comparison with other OFCs (the Bahamas, Bahrain, the Cayman Islands, Panama and Singapore) are rather limited and have not been updated, as they relate to the mid-1970s (McCarthy, 1979). It has been noted that the highest prevalent ratio of total local expenditures to GDP among the countries studies was about 8 per cent. This being so, the current percentage level of 14.7 in Vanuatu compares well with that of other OFCs in the world.

Comparison with tourism

Direct benefits from OFC activities can be compared with those derived from tourism in terms of their respective contributions to GDP. Contribution of tourism to GDP varies from year to year depending on the intensity and the number of cyclones during the season, from November to April each year.

Following the most destructive cyclone, Uma, tourism earnings plunged to the lowest level of 11.5 per cent of GDP in 1987. In normal years prior to 1987, the corresponding ratio was well above 15 per cent of GDP. In recent years (1990–92) owing to intensive tourism promotion efforts, it has been about 25 per cent (Jayaraman, 1993a). Thus, OFC activities, whose contribution to GDP has been about 10 per cent, except for a high figure of 12 per cent in 1986, ranks behind tourism.

Indirect benefits

Indirect benefits, which cannot be quantified with accuracy, are nevertheless important. In qualitative terms, their contribution lies in terms of modernization of the economy. They relate to (a) improvements in the local financial system; (b) development of skills; and (c) linkages with other sectors.

Improvements in the local financial system

The presence of offshore institutions contributes to the development of the local financial system through provision of improved banking facilities. As a result of increased banking practices over the ten-year period, current accounts and savings deposits by ni-Vanuatu citizens in domestic currency have been recording annual increases in recent years, encouraging saving habits and contributing to monetization of the economy.

Development of skills

The number of ni-Vanuatu citizens employed in OFC institutions, which was under 320 and stagnant for three years during 1989–91, rose to about 370 in 1992 and 1993 (Table 6.7). Nearly 50 per cent of them are believed to be involved in technical aspects of financial management and the rest in non-technical aspects, including unskilled areas. Since brain drain through emigration to metropolitan countries is not the serious problem generally witnessed in the Polynesian countries in the South Pacific region, the rate of retention of trained people within Vanuatu is expected to be much higher. As long as the trained persons are retained in the very same OFC institutions or, in the event of horizontal transfers from one to another, among various OFC institutions, the degree of specialization becomes more intensified over time. Except for general clerical and computer-related secretarial work, including reception and front-desk services, the specialized skills gained in OFC institutions are not very relevant to manufacturing, business, retail or trading establishments.

For these reasons, the turnover of ni-Vanuatu citizens employed in OFC institutions is likely to be minimal, and most of them would prefer a lifelong career. To that extent, the number of trained people moving to other establishments with their acquired skills and thereby modernizing an increasing

number of existing trading and financial establishments or setting up new ones, and the fresh sets of ni-Vanuatu citizens being trained in OFC institutions, are not expected to be sizeable. Despite these limitations, the view expressed in the early years of OFC in Vanuatu that, if there were no training in OFC institutions, 'the increased prospects will be only for cleaners, messenger boys and house servants' (Keating, 1972) appears, in retrospect, to be too pessimistic, and at any rate, in the context of steady growth in recent years, it is no longer valid.

Linkages with the rest of the economy

As noted earlier, the forward and backward linkages of the OFC activities and their local expenditures would be of a substantial nature only when consumption expenditures are on local items. Although most of the expenditures are on imported items, the demand for services which are mainly value-added activities, such as printing, sales and repair services for office equipment, local transport and telecommunications, have created considerable opportunities for employment and income generation. Externalities in consumption by OFCs for these services are believed to have been substantial.

Direct costs of hosting OFC activities

Costs of hosting OFC institutions can be categorized as direct and indirect. Direct costs are (a) supervision and regulation of OFC entities; (b) provision of telecommunication facilities; and (c) education and training.

Supervision and regulation costs

Although establishment of Vanuatu as an OFC dates back to 1971 and implementation of the existing regulations as well as supervision have yielded considerable experience and skills, new legislative measures such as the enactment of the International Companies Act 1992 and pending legislation relating to trust companies and other entities have entailed considerable effort. Presently, legal expertise in almost all areas have been provided by bilateral assistance. In the absence of any data, it would be difficult to determine how much drafting time has been devoted to new legislation. Further, setting up a new Financial Commission and designating the present Registrar of Companies under the Act as the Financial Commissioner with greater regulatory powers and expanding the office would create additional demand for skills. Most of the incremental number of positions may be filled partly by redeployment from elsewhere within the government bureaucracy and partly by expatriate assistance.

As regards actual supervision, secrecy provisions themselves tie the hands of the government since investors look for as little prying as possible by the

officials. In the absence of any strict supervision, the slightest whiff of financial scandal is enough to send investors in search of another tax haven. Secrecy and supervision do not go well together (Casanegra de Jantscher, 1976), and reconciling these seemingly conflicting aspects does impose high costs.

Telecommunications facilities

Vanuatu's infrastructure in terms of provision for power and telecommunications facilities has won international acclaim for efficiency. However, generation, operation and distribution costs are considered the highest in the region (World Bank, 1993).

Education and training

In the context of a widespread lack of high school graduates, skilled persons in accountancy, computer operations and secretarial services in Vanuatu, the OFC entities have drawn the best available manpower by paying attractive salaries. As noted earlier, the training in OFC institutions happens to be highly specialized, and hence the horizontal movement of the trained ni-Vanuatu citizens to other occupations has been negligible. Further, the near-stagnation in employment figures in OFC institutions during the late 1980s limited incremental additions to the pool of trained people.

Indirect costs

The indirect costs include (a) the restricted autonomy of monetary authorities; (b) constraints to the formulating of coherent tax policy; (c) supervision on tax evasion; and (d) possibilities of international crime.

Restricted autonomy

Although there are clear legal provisions that offshore exempt banks and other exempt entities are prohibited from conducting onshore activities, these companies are permitted to undertake operations in furtherance of their activities. These include keeping deposits in the local commercial banks. Such deposits may include current accounts as well as time/long-term deposits. As there is no legal requirement on the part of the commercial banks to keep the deposits of exempt institutions distinct from the rest, the liquidity position of the banks and, consequently, the money supply of the country tends to be overestimated. Further, these deposits are subject to withdrawal by the exempt institutions at any time for transfer anywhere, as there are no exchange controls. Since there is strict confidentiality of banking operations in regard to deposits by exempt institutions, as ensured by the secrecy provisions, the central bank's autonomy tends to be impaired to an extent in regard to control over money supply.

Constraints to formulation of coherent tax policy

In the context of a declining trend in the flows of official development assistance to Vanuatu, affecting the fiscal balances, as well as poor prospects in the world market for primary commodity exports, the government has to step up its efforts to mobilize greater domestic resources. This calls for tax reforms but without adding to the already prevailing highly regressive tax structure, which relies heavily upon trade and commodity taxes. The ministry of finance officials fear that any change in policies relating to taxation may destabilize OFC institutions. Consequently, the reluctance to consider necessary changes seriously constrains the formulation of coherent tax policies.

Supervision of tax evasion

Substantial pressures are continuously being put on Vanuatu by the governments of the metropolitan countries in the region to exercise caution in regard to potential tax dodgers. These pressures have imposed heavy costs on Vanuatu's authorities for keeping a watch as well as answering queries from the concerned overseas governments. Additionally, publicity campaigns for a 'clean image' for Vanuatu to counter the 'discrediting efforts' of outsiders have become a necessity requiring time, effort and money.

Watch on international crime

Vanuatu is intensely aware that OFC activities have the dangerous potential to open the doors 'for admitting permanent linkages between the small island economies and the international criminal world' (McKee and Tisdall, 1990). Although there are penal provisions in the legislation, including powers to confiscate money tainted by laundering or drug operations, it requires enormous efforts on the part of the authorities to exercise these powers as well as caution on the part of the banks in accepting deposits.

The OFCs involved in such questionable deals in many Caribbean islands in the mid-1980s had to wait for several years before regaining international confidence. Authorities in Vanuatu have to be constantly conscious of the compelling fact that any such undetected association with suspected international crime might permanently alter the island's future development options, and the costs involved are substantial.

Evaluation

An overall assessment reveals that the importance of OFC activities lies in their modernizing influence on the economy. Although the activities are confined to Port Vila, monetization of the economy and improved banking practices are the benefits derived on a countrywide basis. In measurable terms, OFC activities' contribution to GDP is about 10 per cent. However, this

measures only value-added activities undertaken in OFC institutions. There is a possibility of underestimation since there have been observed deficiencies in reporting by OFC institutions and not all of them report to the official agency in charge of compilation of national accounts.

Although indirect benefits at the outset appear to be substantial, there are many leakages, including imports, to reduce the benefits emanating from the local expenditures of OFC. Employment opportunities have been stagnating, and specialized skills are not very relevant to other non-OFC establishments. Government revenue derived from OFC institutions is modest, at 3 per cent of GDP, and is about 11 per cent of total revenue. On the other hand, direct costs and indirect costs have to be recognized. These mainly relate to supervision and regulation, with emphasis on maintaining the integrity of OFC operations and keeping a constant vigil on questionable deals. Any failure on this account would have a lasting adverse effect and the policy-makers have to examine seriously whether OFC activities can be really relied upon as one of the engines of growth.

Conclusions and Recommendations

Vanuatu now has two decades of experience in OFC activities. Its highly specialized institutions have done well and managed to place the country on the world map as one of the few pure tax havens with a high degree of sophistication and untarnished reputation. The contributions of OFC to growth and modernization have been well recognized and the government has high expectations from them.

In the context of declining prospects in the world markets for the traditional exports of copra and other primary products, the island economies have been forced to find new sources of growth. Accordingly, along with tourism Vanuatu has chosen to rely upon exports of OFC services. However, just as tourism receipts are adversely affected by the destructive impacts of cyclones, OFC services' contribution is susceptible to its reputation and integrity, protection of which is a joint responsibility of the government and OFC institutions themselves. Added to these considerations, one has to be aware of the severe constraints that the tax haven status has imposed on the formulation of national fiscal policies, since any change in domestic tax policies has an impact on OFC operations.

Implications for government

The empirical examination of determinants of OFC activities in Vanuatu, although based on limited data, indicates that local taxes and levies in the past had no impact on OFC institutions. In the context of the current 'high international friction matrix' elsewhere in the world, the government should take full cognizance of its current attractive 'zero friction status' to OFC institutions, especially to exempt companies. There is considerable scope for

raising the current level of registration fees, which are applicable to exempt companies, and both registration and business licence fees applicable to other OFC institutions. Such additional imposts on OFC activities may substantially alleviate the highly regressive impact of commodity and trade taxes, which has to be borne to a large extent by the disadvantaged and low-income groups of the country in the absence of direct taxation. The exact quantum of increases in fees has to be examined as part of an overall resource mobilization effort in the context of the government's declared policy of no direct taxation of any kind in the short run.

Implications for OFC institutions

The OFC institutions should realize that their contributions should be more visible and credible. First, it should be recognized that the collection and compilation of data on OFCs relating to employment and local expenditures, especially on various components, needs considerable improvement since it has been observed that there have been lapses in the past in notifying the agencies, in the form of either no reporting or incorrect reporting. The Vanuatu Financial Center Association (VFCA) should consider it in its own interest to highlight its members' achievements and present accurate data on employment and local expenditures. To this purpose, VFCA might do well to establish a research wing for data collection and compilation. A triennial survey of its constituents' expenditure patterns could also be undertaken by the VFCA so as to determine the multiplier effects of its members' local expenditures. Other areas of research could include employment profiles, training achievements and relevant indicators.

In the light of stagnant employment opportunities and consequent limited possibilities in training in OFC institutions, which are not considered very relevant except to similar financial institutions, OFC institutions' isolated but well protected and continued existence during the past two decades may result in tensions between those engaged in subsistence-oriented activities and purely urban-based enclave-type operations. The institutions' current low contribution to government revenues and identity with urban occupation, unlike countrywide tourism activities, may further compound the problem. Having utilized the hospitable climate of Vanuatu, including the pure tax haven facilities, and having drawn upon the best among the limited manpower for two decades, it would be a fine gesture if OFC institutions considered contributing towards human resource development.

The VFCA might consider earmarking funds from its subscriptions for strengthening the middle- and high-school-level curriculum in mathematics through development of teaching materials and sponsoring teachers from overseas in selected schools in the country. Additionally, it might consider offering full fellowships to aspiring employees in OFC institutions and financing their higher education overseas in accountancy and other areas of

relevance. In the longer run, VFCA might also consider setting up and running a business training college in Vanuatu by raising funds not only from its constituents but also from fellow expatriate business enterprises.

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Notes

1. These include the Bahamas, Bermuda, the Cayman Islands, the Channel Islands, Hong Kong, Liechtenstein, Luxembourg, the Isle of Man, Panama, Switzerland and the British Virgin Islands. For a detailed presentation of these facilities, see Economist Intelligence Unit (1987).
2. Another view is that such measures by Britain and the Netherlands towards supporting OFC aspirations reflected 'their uncomfortable position in their anachronistic role as colonial masters and their unwillingness to continue subsidizing their remaining possessions' (Peagam, 1989).
3. The British authorities' attitude has been particularly positive towards Jersey's initiatives in regard to OFC growth, 'given the island's marginality to mainstream UK policies'. Since the Channel Islands assisted the UK balance of payments to the extent of £100 million each year, there would seem to be acquiescence to the OFC activities, provided that blatant tax evasion or money-laundering is not seen to be encouraged (Hampton, 1994a).
4. It is understood that the Vanuatu Finance Center Association attempted to undertake a survey of employment and expenditures through a questionnaire circulated to its constituents, but the response was found poor, leading to the abandonment of survey efforts.

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