

CHAPTER 4 : THE INVESTMENT CLIMATE

“In an increasingly global economy, factor inputs have become less and less important as sources of productivity and sustained growth. Countries are no longer constrained by their factor inheritance in creating competitive firms and environments. In this sense, competitive advantage no longer rests on a country’s natural endowments, but on that ability to create a business environment, along with supporting institutions that allow the nation’s inputs to be used and upgraded in the most productive manner.”

Porter, M. (1990). *The Competitive Advantage of Nations*.

4.1 As discussed in Chapter 1, the sub-region has experienced a secular decline in private investment over the 1990s (see Figure 1.6). This chapter seeks to understand which elements of the investment climate within the OECS countries are contributing most to this trend and how they could be addressed. In addition, it examines the success of the OECS in attracting record levels of FDI and the likelihood of these trends continuing in the future.

4.2 The investment climate can be defined as the “policy, institutional, and behavioral environment, both present and expected, that influences the returns and risks associated with investment”.¹ This environment is generally seen as having the following three main components:

- **Political and macroeconomic stability** is a pre-requisite for private investment, both domestic and foreign. Numerous studies have demonstrated that a country’s macroeconomic conditions, including its fiscal, monetary and exchange rate policy, are among the most important determinants for FDI.
- A **sound regulatory framework and efficient supporting institutions** to enforce the relevant laws and regulations are necessary for investors to enter the market and thrive. In a globally integrated competitive market, the costs of starting and operating a business have a large impact on choices of country location by an investor and how much contribution the investment will make to the host economy.
- An **adequate physical and social infrastructure** complements a good policy and regulatory framework to create the necessary environment for attracting and retaining investment. These include the quantity and quality of power, transport and communication systems, access to finance, a qualified labor force, and the provision of social services.

A. Macroeconomic conditions for investment

4.3 Numerous studies have demonstrated that a country’s macroeconomic conditions, including its fiscal, monetary and exchange rate policy, are among the most important determinants for both domestic and foreign investment. There are three main channels through which macroeconomic conditions in the OECS affect investment: the impact of macroeconomic stability on firms’ investment plans and their assessment of risk; the effect of the size of government on the space in which firms have to operate; and the impact of openness on level of competition in the market and on the cost and availability of inputs. The latter has been covered in Chapter 3. This section will focus on the first two channels.

¹ Stern (2002).

(i) Macroeconomic stability and private investment

4. 4 As discussed in Chapter 1, **the OECS has maintained relatively high investment rates over the last two decades, averaging 31 percent of GDP, but this stability masks significant shifts between public and private domestic investment over the period.** In contrast, FDI has remained relatively constant throughout. Private domestic investment grew significantly from the early 1980s through the mid 1990s, almost entirely offsetting the sharp drop in public investment due, in part, to a contraction in aid flows (see Figure 1.4). Then in the mid 1990s, private domestic investment began a steady downturn and has been declining since (see Figure 1.6).

4. 5 **This decline in private investment coincides with a rapid deterioration in fiscal performance across the sub-region that began in the mid 1990s** (see Figure 1.7). Over the last eight years, the fiscal position of the sub-region has declined sharply, resulting in public dis-savings, marked increases in public debt, and in several cases the accumulation of both domestic and external payment arrears. The overall government deficit for the sub-region, which had averaged 3.5 percent of GDP during 1990-1996, rose to 11 percent in 2002. Some of the countries have been running primary deficits since the beginning of the 1990s. In others -- St. Lucia and St. Vincent and the Grenadines -- the deterioration has come more recently after a period of more prudent fiscal policy. Although the reasons for each country's deteriorating performance vary, in general they have been associated with a steady rise in expenditures, from an average of 29 percent of GDP during 1990-1996, to 35 percent of GDP in 2003. These increases were driven primarily by a rise in the wage bill and capital spending. In a number of cases, the rise in public investment spending has been associated with reconstruction after natural disasters, but in many it has also been associated with the election cycles. Regardless, the impact on private domestic investment has been substantial.

4. 6 **Since 2002, most countries in the sub-region have taken steps to correct the growing fiscal imbalances, although to varying degrees.** Thus, the overall central government balance in the OECS on average improved to -6 percent of GDP in 2003. Notably, Dominica's stabilization and adjustment program has resulted in a turnaround in both economic growth and the earlier, very sharp, contraction in private investment.

4. 7 **However, the very high levels of public indebtedness of the sub-region may continue to impact private investment for some time.** Public sector debt reached 113 percent of GDP in 2003 for the sub-region, ranging from 70 percent in St. Lucia to 172 percent in St. Kitts and Nevis. Theory states that in the presence of high fiscal deficits and rising public debt, firms will adjust their investment plans downward in anticipation of increases in future taxation needed to repay this debt. While firms in the OECS may not anticipate that tax rates, which are already quite high, will rise, they may expect a reduction in widely used tax concessions. However, they may also foresee that the necessary fiscal adjustment will involve significant reductions in public expenditure reductions. In the short run, as wage and capital spending decline, firms may anticipate a further contraction in the demand for their services, but in the long run, these reductions will create more space for the private sector in the economy.

4. 8 **The impact of a deteriorating fiscal position and debt overhang has not affected FDI inflows as much as it has domestic investment.** FDI inflows continued to rise as fiscal imbalances rose in Antigua and Barbuda, Grenada, and St. Kitts and Nevis, while in St. Lucia it declined throughout the 1990s including during the earlier period of fiscal prudence, and in St. Vincent and the Grenadines the trends are in the opposite direction. Only in Dominica does there appear to have been an impact similar to the one seen in private domestic investment.

4.9 **Monetary and exchange rate policy has been instrumental in maintaining relatively stable levels of FDI.** In a study of the economic performance of ten Caribbean islands from 1980 to 1992, McCarthy and Zanalda (1995) find that the high and steady levels of FDI inflows to the OECS were made possible by having a monetary board (see Box 4.1) which ensured monetary and exchange rate stability.

BOX 4.1: THE EASTERN CARIBBEAN CENTRAL BANK.

The Eastern Caribbean Central Bank has the legal mandate of maintaining the fixed parity between the Eastern Caribbean dollar and the U.S. dollar. It has full central bank functions including: issuing the common currency, managing a common pool of foreign exchange reserves for member countries and maintaining monetary conditions conducive to growth and development. The ECCB is required to maintain foreign exchange reserves to cover only 60 percent of its demand liabilities, but has maintained reserve backing of close to 95 percent which has helped to bolster the fixed exchange rate regime.

4. 10 **One reason may be that foreign investors coming to the OECS have some level of confidence in their operations being insulated from the fiscal position of host countries.** Take the case of a large resort hotel that has been granted a 20 year tax holiday and duty concessions, which co-generates its own electricity, desalinates its own drinking water, imports most of its inputs, transports its guests to and from the airport, and conducts the majority of its business in US dollars. With the exception of key public infrastructure like the air and sea ports, the state of the country's fiscal and economic position, short of an exchange rate crisis or civil unrest, is less of a concern than conditions in the external market place. However, as the OECS pursue foreign investment with greater backward linkages, the macroeconomic conditions, both fiscal, real and monetary, will be of increasing importance to investors.

(ii) The size of government

4. 11 **The government sector in the OECS is relatively large, and has been growing during the 1990s.** During 1998-2003, government spending represented 34 percent of GDP – ranging from 29 percent in St. Lucia to 41 percent in Dominica. The sector has been growing in importance since the beginning of the 1990s, when it represented 30 percent of GDP (during 1990-1995). On average, the OECS countries have larger governments in terms of spending than the rest of the Caribbean where spending averages 30 percent and other upper middle income countries were it averages 22 percent of GDP. Government services represent 15 percent of GDP, and the state sector provides about 20 percent of employment. It is notable that the government services were a leading driver of growth in the 1980s and 2000s.

4. 12 **Small states have been shown to have large governments for several reasons.** The size of government in the OECS as measured by spending is not out of line with other micro states (see Table 2 in Introduction). Existing literature on size of government has shown that there is a negative correlation between the share of government consumption in GDP and population size. Alesina and Wacziarg (1997) interpret this result as evidence of economies of scale in the production of public goods, while Rodrik (1998) argues that smaller economies are more open to trade with the rest of the world and, as a result, more volatile. To mitigate this higher volatility, the argument goes, countries develop a larger government sector. Finally, Eskeland et al (2004) find that countries, like those in the Caribbean, with strong voice and governance and the associated strong democracies, tend to have larger government sectors, for example to provide basic education and health, as well as infrastructure. Intuitively, all of these explanations could hold for the OECS countries, yet they do not explain the recent growth in the public sector.

4. 13 **Experience in the wider Caribbean in the 1960s and 1970s, for example in Jamaica and the Dominican Republic, provides ample evidence that there are dangers to expanding the role of the public sector.** During this period, governments intervened in markets through price and investment controls and the establishment of public enterprises generally in a desire to speed development, and on the basis of traditional economic rationales for the public sector, such

as addressing natural monopolies, income redistribution, “merit” goods and market failures, externalities and public goods. However, these market interventions protected high cost, inefficient public and private enterprises, and led to a slowdown in growth.² The public enterprises usually had difficulties in charging prices that covered costs or in collecting fees; they usually provided poor service, and often were “captured” by the employees or particular groups in society to the detriment of customer service at reasonable costs. In general, the public sector had difficulty in replicating the pressures for efficiency generated by market discipline and in shielding itself from corruption.

4. 14 Large government spending, particularly for a government that does not deliver services commensurate with the high tax level that supports it and the high debt it has incurred, tends to dampen private sector-led growth. First, high levels of government debt generate high risk premiums and tend to deter and crowd-out private investment. Second, the high level of taxes necessary to support large government, particularly taxes on formal sector enterprises and persons in the formal sector, deters investment and foreign investors. Tax incentives to offset these taxes are undesirable because of their distortionary effects. Third, high levels of government spending that are not effective in delivering education, health and infrastructure services, do not contribute to private sector growth. Fourth, as a large employer, government wage-setting mechanisms which are generally not entirely market driven can distort the functioning of the labor market, and create wage inflation through the economy. A private sector-led development strategy depends on reforms in government that improve its effectiveness and reduce its cost.

4. 15 Across the Caribbean, the transition to private-sector led growth has been neither automatic nor easy. In the 1980s, these countries embarked on a transition to a private sector-led, market-based development strategy and began to reform their public sectors, but the transition has been neither automatic nor easy. Protection of inefficient import substitution was cut, exports were promoted and regulations limiting markets and red tape were reduced. Public sector reform and containment of government expenditures have been less successful, however, in part due to the political economy that has developed around the role of the state, over many years of government intervention.

4. 16 The OECS countries will need to embark on a similar path of public sector reform, if they are to depend on private-sector led growth. The path of development of the OECS during the last two decades has confirmed the limitations of public sector-led growth. Given the current fiscal instability and high levels of indebtedness, the sub-region has little room for maneuver. As with the rest of the Caribbean, the challenge of public sector reform is a complex one given the political economy of the sub-region.

4. 17 The way forward will depend on addressing the political economy issues head on. As illustrated in the Ireland case study (Chapter 3), the governments of the sub-region will need to articulate a strategic vision of the future, alongside private sector and civil society, and to build a social pact for implementing the transition ahead.

² Worldwide, measured growth tends to rise when import substitution occurs. However, much of that growth typically reflects deficiencies in national accounting methodology; the new firms’ value added is added to national accounts without adjusting for the difference between international prices and the higher prices of import substitutes resulting from protection. In the longer run, as import substitution possibilities are exhausted, growth becomes more capital intensive and tends to slow.

B. The role of public investment

4.18 **Most of the OECS countries pursued expansionary fiscal policies during the 1990s mainly through increasing public investment, as a means of sustaining growth in the short run and crowding in private investment.** However, the impact of these policies has generally not been as expected. Notwithstanding the other contributing factors to the slowdown in growth and private investment, the effectiveness of these public investments has been a key issue.

4.19 Table 4.1 presents the sectoral distribution of public investments by OECS central governments during 1995-2001. Notably, the share of expenditure going to economic infrastructure has been declining steadily since 1996, reallocated mainly to the social sectors, general public service and the category “Other”. Indeed, general public service and “Other” account for more than Social Sectors for most of the period. As expected, the allocation for tourism has been increasing and that for agriculture decreasing.

TABLE 4.1: SECTORAL COMPOSITION OF PUBLIC INVESTMENT, 1995-2001
(% of actual capital expenditures)

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | Avg 1995-01 |
|-------------------------|------|------|------|------|------|------|------|----------------|
| Economic Infrastructure | 37 | 44 | 43 | 43 | 38 | 26 | 29 | 36 |
| Economic Sectors | 30 | 19 | 18 | 17 | 17 | 15 | 16 | 18 |
| Agriculture | 22 | 15 | 13 | 8 | 10 | 5 | 7 | 11 |
| Tourism | 3 | 3 | 4 | 6 | 3 | 8 | 7 | 5 |
| Other | 5 | 1 | 1 | 3 | 3 | 2 | 1 | 2 |
| Social Sectors | 16 | 22 | 19 | 18 | 23 | 29 | 27 | 23 |
| General Public Service | 5 | 7 | 11 | 10 | 9 | 14 | 12 | 10 |
| Other | 12 | 8 | 8 | 12 | 13 | 16 | 17 | 13 |

Note: excludes Antigua and Barbuda for all years, St. Kitts and Nevis in 1995 and 2002, St. Vincent and the Grenadines in 1995 and 1996, and Dominica in 2002.

Source: World Bank (2003e, 2004f, 2004g, 2004h, forthcoming).

4.20 **One issue to be considered is that a significant fraction of capital budgets has gone toward reconstruction after natural disasters, which have increased in frequency in the 1990s.** In three out of the seven years presented in Table 4.1, the sub-region was struck by catastrophic hurricanes which devastated several islands in a short space of time³. However, a closer examination of the post-hurricane spending patterns in a number of countries undertaken in the recent public expenditure reviews prepared by the World Bank (2004, 2005) also reveals that there is a tendency for subsequent increases in capital spending to become permanent rather than temporary shocks.

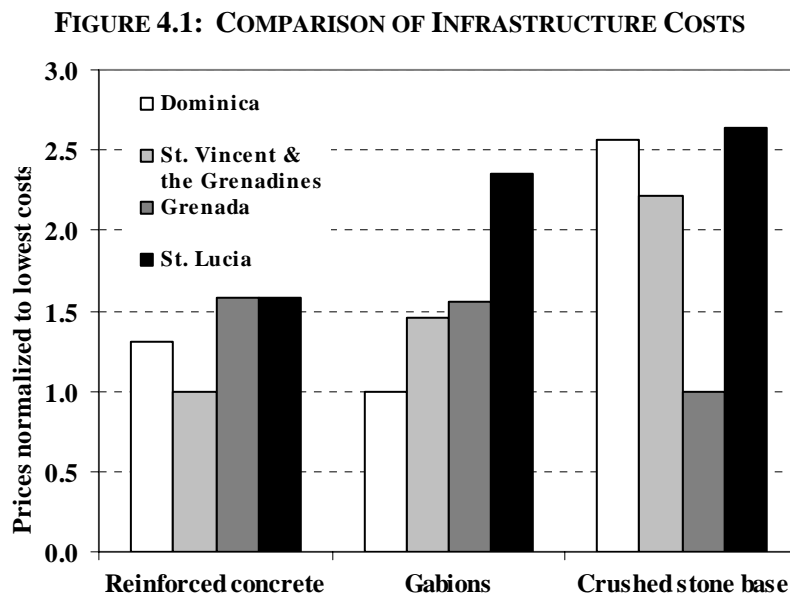
4.21 **Weaknesses in the formulation and implementation of public investment programs appears to have been at the heart of the problem.** As illustrated by the recent Analyses of Fiscal Issues, projects in the Public Sector Investment Programs (PSIPs) are generally selected as a process of negotiation between Ministries and Cabinet members, and often announced to the public, prior to technical discussions on their feasibility, if any. Some countries have formalized the process by introducing explicit procedures for project review and selection, prior to Cabinet consideration, but this practice is not yet common across the sub-region. Generally, the tradeoffs between investments are not based on a comparison of their projected economic and social impact. Many reportedly “strategic” public investments – such as sports stadiums, marinas,

³ Hurricane Louis in 1995, Hurricane Georges in 1998, and Hurricane Jose and Hurricane Lenny in 1999.

airport, fishing complexes – have not necessarily been supported by overall strategic plans embodied in sector analyses that indicate how these investments were to impact private investment. Financial and technical requirements for operating and maintaining these investments are discussed only toward the end of construction. And consultation with stakeholders are rare during both project preparation and implementation.

4.22 **These issues have been exacerbated by a lack of coordination among donors, and inadequate oversight of project preparation by financing agencies.** In a number of countries public investment figures have been overstated by the inclusion of donor-financed projects that support recurrent spending (such as technical assistance and preparation of reports). When Dominica recently began a process to rationalize its PSIP, there were over 100 projects for a total capital expenditure of EC\$66 million ranging from EC\$12,000 to EC\$35 million supported by 16 different donors. Many of these had been negotiated by the donors with line ministries without the significant involvement of the Ministry of Finance and Planning. The plethora of tiny projects, some with questionable priority or impact, overstretches planning ministries' limited capacity to manage these programs.

4.23 **A third issue impacting the effectiveness of the public expenditure programs is value for money.** The World Bank's experience with financing civil works across the sub-region reveals a wide disparity of unit costs among projects in different OECS countries. These reflect differences in procurement practices as well as the level of competition in the different local construction sectors. Figure 4.1 presents a recent comparison of costs of some basic civil works inputs within the OECS.



Source: Staff estimates.

4.24 The following reasons have been suggested as contributing to the high costs of public investment outputs.

- **Lack of standardized procurement rules** which can limit competition between suppliers and service providers.

- **Over-design by consultants**, i.e. projects are often designed without consideration of budget constraints and do not reflect actual needs and requirements. One donor official can be quoted as stating, after receiving early consultants reports on an already agreed investment, “there is definitely going to be a cost overrun, but we will deal with that problem when we get there, let’s just get this project started.”
- **Poor contract management** as evidenced by the large number of contracts in which the actual output or expenditure varied from what was contracted, but standard procedures were not followed to clarify or correct them.
- **Lack of oversight of ongoing works** by ministries due to a shortage of qualified staff.

4.25 **Good procurement practices have a direct and positive impact on the cost and quality of all government purchases.** Because the government is a large player in the local economy, they also contribute to establishing a fair and competitive playing field for the private sector. **Across the OECS, however, public procurement systems suffer from a number of key weaknesses.** The regulatory framework is outdated and in some cases incomplete, practices are not transparent, controls are weak, enforcement of rules lax, and there is a tendency toward very highly-centralized discretionary decision-making on contract awards.

4.26 A full procurement assessment of the OECS has been shared with the member countries⁴ and an action plan prepared and discussed at a recent workshop. The following are a few recommendations (some additional) on how to address this issue:

- A sub-regional program to reform and harmonize procurement systems would help to conserve limited technical capacity and help to strengthen controls and accountability.
- Opening local bidding to the sub-regional market will help to prevent capture by local firms.
- Introducing a system of peer review by donor agencies may help to provide better oversight and supplement local capacity.

4.27 **As noted above, the financing of the expansion in public investment has been a key contributor to the rapid increase in debt levels across the sub-region.** Expensive commercial borrowing or turnkey construction contracts contributed significantly to the rise in indebtedness in St. Kitts and Nevis, Dominica and Grenada. In many cases, these obligations were negotiated with persuasive regional financiers or international construction companies without sufficient competition between service providers or adequate expertise on the part of the governments to weigh the financial risks. The back door nature of these deals leaves governments open to risk. Some officials report that they have resorted to commercial financing when donor resources were “too slow” in coming and they were under pressure to provide targeted public infrastructure, such as access roads, to facilitate FDI projects.

4.28 Capacity building can be addressed over time with technical assistance on debt and financial management for Build-Operate-Transfer and similar operations. However, provided the upfront feasibility and strategic priorities of the project have been established, the OECS Governments would do well to pursue more open and competitive approaches to securing financing, which allow for public scrutiny. In this regard, **it is the recommendation of this report that the sub-region undertakes an overhaul of the legislation and systems governing the contracting, management and disclosure of public debt, including contingent liabilities.**

⁴ World Bank (2003f).

C. The investment incentives regime

4. 29 As discussed in Chapter 3, the OECS countries have performed exceptionally well vis-à-vis the rest of the world in attracting a record share of FDI with respect to their GDP. However, in recent years this rank has fallen and their share of Caribbean FDI inflows has also declined.

4. 30 **The OECS countries have traditionally relied primarily on a range of fiscal and financial incentives for attracting foreign investment.** These include three main types of incentives: (i) statutory provisions which offer tax holidays or income tax relief, (ii) exemptions from taxes on imported products – some of which are specified in legislation and others which are at the discretion of high level government officials, and finally (iii) special packages negotiated at the discretion of Cabinet members which have included government guarantees, special land deals, and targeted infrastructure investments. Most of the countries have a Fiscal Incentives Act, a Hotels Aid/Tourism Incentives Act, and an Aid to Pioneer/Development Industries Act aimed at the exporters, hotels and manufacturing respectively. Tax holidays are provided for each of these and in the Income Tax Act as well. There is involvement at a very high level of government for the approval of both statutory and discretionary incentives.

4. 31 **Although most of these regimes were originally devised under the 1973 CARICOM Agreement on Harmonization of Incentives to Industry, countries have departed significantly from that agreement.** For example, tax holidays under the Hotels (Aid) Acts in the OECS range from 5 years in Antigua and Barbuda to 20 years in Dominica. In St. Kitts and Nevis the duration depends on the size of the property, and in St. Lucia it is share for extensions versus original construction. These incentives now violate the 1973 CARICOM agreement because they are awarded on the basis of sector and project characteristic rather than domestic value added.

4. 32 **The result has been the development of very intense incentives-based competition for FDI across the sub-region and the Caribbean region as a whole.**

4. 33 **These incentives have been very costly in terms of foregone revenue.** Unfortunately little data is collected by any of the governments on foregone revenue due to tax holidays, in part because investors are rarely required to submit annual financial reports once they have set up operations. Data is more readily available on customs duty and consumption tax concessions, for which foregone revenues amounted to an average of 18 percent of GDP in St. Kitts and Nevis during 1996-2000, 10 percent of GDP in Antigua and Barbuda during 2001-2003, and 5 percent and 6 percent of GDP in Dominica and St. Vincent and the Grenadines, respectively, in 2001.

4. 34 **In general, it is difficult to measure the net benefit of investment incentives *ex ante*,** first because the counterfactual that the investment would not have been realized without the incentive is hard to prove, and second, because, if successful, it should have both direct and indirect impacts on the economy. Value-added is a very useful goal at the conceptual level, but precise calculations of the value to be added by investment projects are nearly impossible in practice.

4. 35 **The negative impact of incentives-based competition for FDI is not only financial.** Because they are not clearly based on any clear economic rationale – market failures or public goods – these incentives distort the returns to investment across activities, sectors and enterprises leading to less efficient resource allocation. In addition, if they are applied in a discretionary manner as the majority are in the OECS, they create uncertainty among investors as well as open the door for corruption and rent-seeking.

4. 36 **The type of incentives used in the OECS are particularly inefficient.** Tax holidays are not specific to investments per se, but rather to ongoing operations which could be expanding or shrinking over time. At a minimum, they should be replaced with alternatives such as investment tax credits, accelerated depreciation, and loss carry forward provisions as has been done in Barbados. In addition, they should not discriminate between new construction, maintenance, rehabilitation or extensions. These provisions are more closely targeted to actual investments and help to mitigate investment risk.

4. 37 **Not having been updated for some time, the incentives are also inappropriate for new service activities.** For example, in Grenada, a hotel with 10 rooms may receive incentives, but a yacht that can accommodate many more guests is not eligible. In St. Vincent and the Grenadines, two new yachting operators – a business that does not require a substantial investment in fixed costs (the companies manage yacht pools for individual private investors) – were given substantial tax holidays, which resulted in driving the incumbent operator out of business.

4. 38 **Duty concessions and other exemptions from taxes on imports, which attempt to bring products closer to world market costs, are only required or demanded because of the high tariffs and other trade-related service charges imposed by the OECS countries** (see further discussion in Chapter 4, and Table 3.2). A number of the governments across the sub-region are making attempts to tighten the use of duty exemptions, but this has been generally limited to reducing those granted at the Cabinets' discretion, while statutory concessions remain. At a minimum, concessions should apply to particular products, rather than prescribed by use or user, as is commonly done in the sub-region.

4. 39 **As barriers to international investment fall worldwide, competition for FDI has increased.** Within that competition, incentives-based competition remains a global phenomenon. Developed and developing countries, and their sub-national regions engage in it worldwide. A recent survey of 45 developing countries found that 85 percent offered some kind of tax holiday or reduction of corporate tax income for foreign investment.⁵

4. 40 **However, there has been a consistent stream of evidence⁶ from firm surveys showing that fiscal incentives are not the primary criteria in their overseas investment-location decisions.** A survey conducted by the Multilateral Investment Guarantee Agency (MIGA) of 191 companies with plans to expand operations overseas found that only 18 percent in manufacturing and 9 percent in services considered grants and incentives to be influential in their choice of location (MIGA, 2002). Of 75 Fortune 500 companies surveyed by Wunder (2001), only four identified them as influential. The literature is well summarized in a recent review by Zee, Stotsky and Ley (2002).

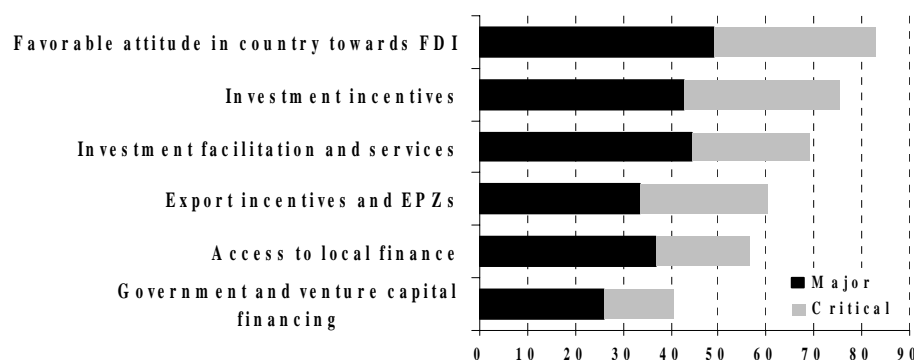
4. 41 **This research has shown that firms generally make their investment location decisions in a two-stage process.** The first is based on 'fundamentals' – the match between country-specific conditions and the investment, the general investment climate, and the availability and cost of key factors of production, labor, infrastructure, etc. In the second stage, firms draw up a short list of potential locations. At this stage, when alternative locations are otherwise closely matched, differences in tax obligations can influence decisions at the margin. Annex 2 lists the alternative locations for OECS countries that were reported in a recent Caribbean Foreign Investor Perception Survey.

⁵ World Bank (2004b).

⁶ Lim (1983) and Ernest & Young (1994).

4. 42 When considering the FDI framework Caribbean investors did rank investment incentives as their second highest concern after “General attitude in the country toward FDI” (see Figure 4.2), but when considering the overall investment climate, investment incentives ranked only 16th out of 40 areas (see Annex 1). They were surpassed by several factors including the infrastructure and labor issues and, notably, by tax rates, favorable attitudes toward FDI, and clarity and fairness of law and regulations. This suggests that foreign investors in the Caribbean do follow the general process described above, and that incentives may remain important at the second stage of location decisions, after the fundamentals have been deemed appropriate.

FIGURE 4.2: GRENADIAN INVESTOR PERCEPTIONS OF THE FDI FRAMEWORK



Source: World Bank (2004a).

4. 43 **Competition among countries has made these incentives an even more risky and costly prospect for OECS governments.** There are numerous experiences around the Caribbean and in the OECS where incentives were granted that have not resulted in the expected job creation and income generation and have consumed public resources that could have been used to raise the quality of the broader investment climate instead. St. Lucia’s recent experience with a government guarantee for a hotel that went bust and St. Vincent and the Grenadines’ experience with Ottley Hall Marina are two of the more costly experiences in the sub-region.

4. 44 As para. 7.31 in the tourism case study shows, **simply competing by incentives in the general melee of worldwide FDI flows without paying sufficient attention to the fundamentals of the domestic investment climate will generally yield footloose or enclave type investments that have a limited impact on the local economy.** Other nations have taken a different strategy to attract investment lowering taxes and concentrating on other elements of the investment climate and investment promotion. International experience (e.g. Mauritius and Ireland) has suggested that lowering corporate tax rates may be a far more effective mechanism for long-term investment attraction than an unwieldy collection of tax holidays.

4. 45 **Given the amount of revenue that is lost on these concessions, and the costly apparatus required to administer these concessions, the OECS countries would be advised to lower both taxes and tariffs and eliminate the general need for the concessions.** The current level of corporate taxes in the OECS – between 30-40 percent – is relatively high, as are the tariffs and taxes on imports (see Table 4.2 below and Table 3.2 in Chapter 3). Indeed, the surveyed investors ranked tax rates above investment incentives as a key issue in their choice of location (See Annex 2).

TABLE 4.2: TAX RATES

| | Corporate Income Tax | Domestic Consumption Tax | Import Consumption Tax | Customs Service Charge |
|-----------------------------------|-------------------------|-----------------------------|---------------------------|---------------------------|
| Antigua and Barbuda | 35 | 15 | 15-50 | 10 |
| Dominica | 30 | 20 | 25 | 3 |
| Grenada | 30 | 5-10 | 15 | 5 |
| St. Kitts and Nevis | 35 | 15 | 25 | 5 |
| St. Lucia | 33 | 0-35 | 4-30 | 5 |
| St. Vincent and the Grenadines | 40 | 5-40 | 5-20 | 4 |

Source: Bain and dos Santos (2004).

4.46 **The investment incentive regime should be focused primarily on those investments which would have a clear strategic role (such as knowledge spillovers), or as the center piece to a cluster of activities for the country.** Only those incentives should be considered for selective interventions. The difference between country experiences with FDI often depends on whether their approach to incentives and promotion is informed by an underlying and detailed development strategy. For example, Taiwan, Costa Rica and Ireland, which have significantly benefited from knowledge transfers from FDI, directly targeted firms that would complement their own investments in education, training and national innovation systems. On the other hand, Mexico, whose approach to FDI was primarily as a source of jobs and tax revenues, has experiences much lower spillovers and backward linkages. Under the more strategic approach, investors are handpicked by the country and approached directly. In the OECS, this will require an appropriate export development strategy and a capable investment promotion agency.

BOX 4.2: ATTRACTING INVESTMENT, COSTA RICAN-STYLE

The announcement that Intel was going to spend US \$300 million to construct a semiconductor assembly and testing plant in Costa Rica came as a surprise to many. The small country of 3.5 million people was an unlikely choice from the list of contending locations that included Mexico, Brazil, Indonesia and Thailand. The notable absence of firm-specific concessions for Intel, side-deals, or large government grants was remarkable. Intel's criteria included supply of professional and technical operators, reasonable cost structure, a "pro-business" environment, specific logistics and manufacturing lead time, and a fast-track permit process. For Costa Rica, Intel would provide the center piece of an ongoing strategy to develop an electronics sector – hence some of the ground work was already laid. The following example illustrates how the Costa Rican authorities accommodated the inevitable requirements of Intel:

Transport. *Intel was worried about the frequency of flights and the capacity of San Jose's airport. The Costa Rican authorities granted more licenses to foreign carriers, and accelerated plans for a new cargo terminal. Intel contributed the land for the access road that would help in general airport traffic patterns.*

Energy. *Intel was concerned about delays in the planned expansion of generation capacity. The Costa Rican authorities convinced them to provide the land and funding for two new power stations, one dedicated to them and another to a neighboring industrial park. The Costa Rican authorities revised the electricity rates structure to differentiate large industrial users, not just Intel.*

Education. *Intel was concerned about the supply of semi-skilled workers. The Costa Rican authorities undertook rapid reform to match the curricula of the country's technical high schools and advanced training programs to Intel's job descriptions, and introduce a one-year certificate, one-year degree program and language training.*

Source: Spar (1998).

4.47 **One approach to reducing investment-based competition is harmonization of regimes across the sub-region and the Caribbean region. However this is likely to be very difficult.** Recognizing this, LeCraw (2003) suggests two options for CARICOM which is in the

process of preparing a harmonized investment code: (i) a uniform low tax rate for all investments projects or (ii) a low tax rate combined with highly targeted incentives but with limits on the incentives that could be granted by member countries. **As a start, it is recommended that the OECS countries improve the level of transparency surrounding incentives by disclosing them to the public on a regular basis.** Public scrutiny can go a long way to reducing waste. In addition “sunshine laws” can be instituted to require opportunities for public comment and access to records.

D. Investment promotion

4. 48 **Notwithstanding the sub-region’s success in attracting FDI, it is safe to say that investment promotion as a public sector function in the OECS is still in its infancy.** Few countries have an agency dedicated to this function. Usually this function rests in the hands of the national development corporation that has responsibilities for administration of fiscal incentives, development and marketing of industrial estates, management of some state-owned companies or joint-ventures, perhaps housing development programs. In addition, other agencies such as a tourism authority, a Ministry of Commerce or Finance, or an export development agency are separately involved in what can be called investment promotion work, but this is rarely coordinated across the public sector. Sometimes as in St. Kitts and Nevis the function has been delegated to the offshore financial services marketing agency. More recently, governments across the sub-region have recognized the need to consolidate and dedicate resources to this function. St. Vincent and the Grenadines has recently established a new agency, the National Investment Promotions, Inc and St. Kitts and Nevis has recently refocused the offshore financial services marketing agency solely to investment promotion.

4. 49 **There are four critical functions involved in effective investment promotion: image building, investment generation, investment facilitation and investment policy advocacy.** Of the four functions, agencies in the OECS tend to focus most of their efforts on the last two functions. As a result, the process of attracting investments remains a very reactive, rather than proactive one.

4. 50 **Regarding investment facilitation, some OECS governments have established “one-stop shops” to reduce the burden on firms that need to receive approvals from a range of different entities before starting operations.** In 2001, for example, its new Act established the St. Lucia Development Corporation as a one-stop shop for investors with the power to grant work permits and some licenses. However, in discussions with various line ministries and special offices each revealed their own role in the investment approval process, not the least of which was the Cabinet itself. This is a common problem worldwide. To the extent that approvals are a response to crucial policy concerns in technical areas, the one-stop shop would have to duplicate expertise and facilities elsewhere in the government. To the extent that they are not, however, then the procedures should be eliminated.

4. 51 **The implication is that establishing a one-stop shop is not simply transferring approval process but involves a whole review and possible re-engineering of these procedures.** For these reasons, most one-stop shops have narrower mandates, with the authority to grant some approvals and provide assistance on others. In some cases, the one-stop shop may house staff from relevant agencies. Box 4.3 showcases some remedies that have been tried in other countries with varying levels of success.

BOX 4.3: ONE-STOP SHOP, OR ONE-MORE-STOP SHOP?

The Tanzania Investment Center houses nine senior officials from other ministries, and normally manages to turn around applications within a few days. The rapid turnaround is due in part to a “no objection” provision written into the investment code – unless a ministry objects within 14 days, the Center is entitled to approve the application.

This approach has been less successful when the lines of authority are not clearly drawn. Set up in 1987, the One-Stop Action Center in the Philippines houses representatives from seven agencies who are responsible for providing information to applicants and acting on some applications. Lack of effective agency representatives and the non-reporting of some representatives led to poor results, requiring the government to reorganize the center in the late 1990s.

When agencies lack authority to grant all necessary approvals, it is important that they still add value to the process and do not just constitute an additional regulatory burden. In Thailand, the Investment Services Center can issue establishment licenses for non-polluting activities, but factories still have to get permission from the Ministry of Industry before production could actually start. To avoid delays later in the process, many firms prefer to obtain the necessary licenses directly from the Ministry, from the outset.

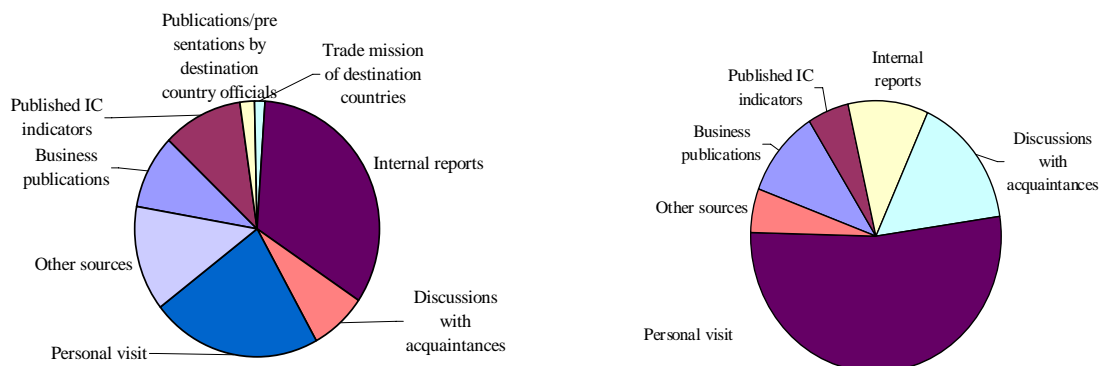
One-stop shops with a narrower mandate have sometimes accelerated the process of gaining specific approvals. For example, by shifting from a pre-auditing to a post-verification system, the One-Stop Service Center for Visas and Work Permits in Thailand reduced the time it took foreign firms to get visas for foreign workers from about 45 days to just 3 hours.

4. 52 The relatively low attention paid to image building and investment generation in the OECS can be attributed to two factors: the lack of a strategic vision for the economy in which the role of FDI is clearly identified and the high costs of these two functions. The first underscores the reactive nature of governments in the OECS to FDI. However, as recommended throughout this report, it is crucial that such a strategic vision be formulated to guide the whole approach to economic development in the future. Otherwise, the OECS countries stand the risk of being buffeted by the waves of globalization.

4. 53 Regional investment promotion agencies have not been very effective in reaching their targeted audience, or significantly influencing the decision-making processes of potential investors. Figure 4.3 reports the sources of information most commonly used by investors in the Caribbean and in Grenada about a particular country. It was found that in most cases, firms rely on their own companies’ internal reports and analysis to get information about a particular country. Personal visits are also quite important⁷. By contrast, investors rarely depend on the more traditional promotional tools, such as trade missions, publications and presentations by country officials, to form their opinions about Caribbean locations.

⁷ Other sources include business contacts through personal relations, acquisition of a local company, and various other informal channels.

FIGURE 4.3: SOURCES OF INFORMATION FOR FOREIGN INVESTORS
CARIBBEAN-WIDE **GRENADA**



Source: World Bank (2004a).

4.54 **With a strategic vision in hand, the benefits of image building and investment generation will more likely outweigh the costs, but a sub-regional approach may be necessary.** Investment promotion can be much better targeted to the types of firms that can facilitate the implementation of that strategy. One study found that FDI increases by 0.25 percent for every 1 percent increase in the investment promotion agency's budget. These agencies tend to be more successful in countries where the investment climate is already amenable to foreign investors: increases in the budget of an Investment Promotion Agency (IPA) increase FDI nearly twice as much in countries with the most favorable investment climates as compared to countries with the least favorable. Nevertheless, as shown in Table 4.3, promotion has been costly in per capita terms, especially at the image building state.

4.55 **This analysis suggests the need for the OECS to re-consider a joint approach to investment promotion⁸ to reduce costs.** This assumes that the sub-region agrees on a joint strategic vision for the OECS, and that competition among the countries for investments be reduced.

TABLE 4.3: THE COST OF INVESTMENT PROMOTION

| | Annual FDI promotion budget (US\$ million) | Population (millions 1999) | Per capita budget (US\$) |
|---------------------------------|--|-------------------------------|-----------------------------|
| Singapore (EDB) | 45.0 | 3.2 | 14.06 |
| Ireland (IDA 1999) | 41.0 | 3.7 | 11.16 |
| Costa Rica (CINDE) | 11.0 | 3.5 | 3.14 |
| Mauritius (MEDIA 1986) | 3.1 | 1.2 | 2.58 |
| Dominican Republic (IPC) | 8.8 | 8.4 | 1.05 |
| Malaysia (MIDA) | 15.0 | 22.7 | 0.66 |

Note: The text in the parentheses is the acronym of the respective country's investment promotion agency.

Source: World Bank (2004b).

⁸ In this regard it will be important to revisit the experience of the joint Eastern Caribbean Investment Promotion Eastern Caribbean Investment Promotion Service (ECIPS). For several years, the OECS maintained ECIPS with donor support. The Service was geared to building the investment image of the region and targeting prospective investors, who could then be funneled to the national promotion agencies of the region. However, that entity closed its operations after a few years due to funding problems.

E. The regulatory framework and administrative efficiency

4.56 **In addition to being small economies, where markets face a greater risk of monopolies or oligopolies, the OECS countries have further discouraged domestic competition through the use of price and investment controls, and government ownership of commercial enterprises.** More than half of the firms surveyed in the Grenada Investment Climate Assessment (ICA) reported that their market share exceeds 50 percent. This is particularly notable for the manufacturing sector, where several products are still protected under quantitative import restrictions. In a number of countries (refer to Chapter 3), the governments have assigned monopoly power for the importation and distribution of key food and export commodities to national marketing boards. For example, the Nutmeg Board in Grenada retains a monopoly on purchasing which is currently hindering a new entrant seeking to produce value added products from purchasing supplies at farm gate prices. In Dominica, the long-standing dominant position of the Dominica Banana Marketing Corporation (in part because of government subsidies) over farm input distribution prevented the development of a competitive sector. Now that the banana industry has declined, there is an important gap in the supply chain for farmers. In other countries the government still retains significant or complete ownership in a number of commercial state enterprises, ranging from commercial banks, dairy farms, housing development projects, radio stations, hotels, flour mills, which entitle these firms to special treatment.

4.57 **In general, the Government's rationale for entering the market is to prevent the abuse of monopoly power by dominant private operators or to achieve some social goal not being delivered by free market competition** (for example through the bulk purchasing, packaging and distribution on basic food items). In the latter, the resulting benefits are rarely effectively targeted to the poor and needy. In the former, the products and services being monopolized are generally tradables whose markets are already being protected by high tariffs. Lowering these tariffs and allowing competition from imports would be a more effective way of controlling the abuse of monopoly power. In the case of retail, uneven granting of duty concessions is creating unfair competition between local operators. According to the Grenada ICA survey, anti-competitive practices were regarded as at least a moderate problem by nearly 20 percent of the firms that reported that they were a major-to-severe constraint to their businesses. While anti-trust rules in some sectors may not be appropriate for such small markets, the OECS should consider the establishment of rules and regulations about the abuse of dominant power and collusion in price setting.

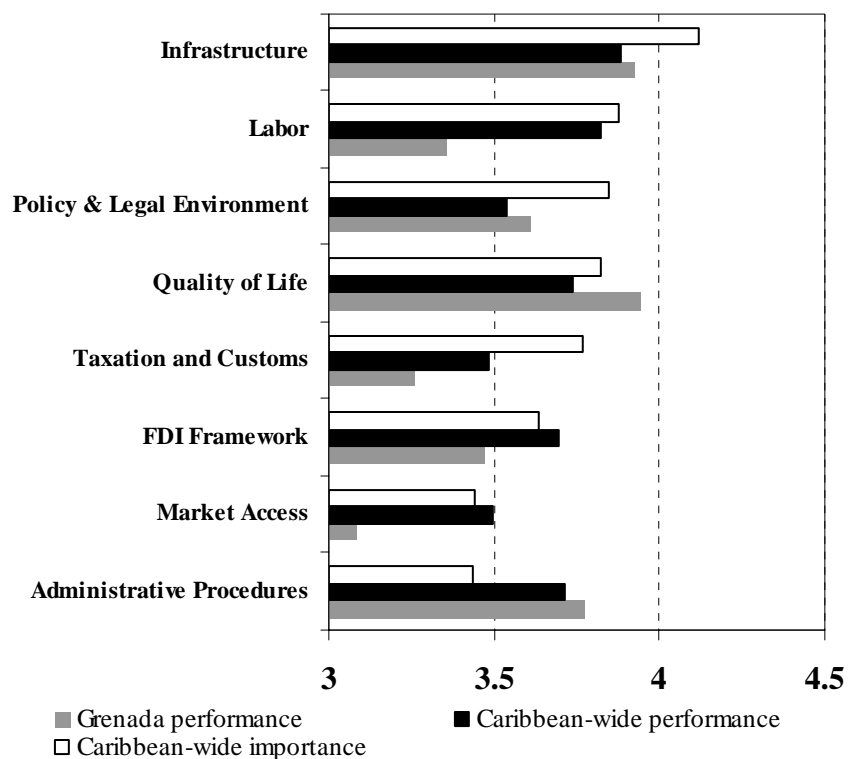
4.58 Finally, most OECS countries have an established negative list of industries ranging from hairdressing to retail and distribution that are reserved for nationals. Most OECS countries retain Alien (Landholding) Acts under which foreign investors must obtain a license to purchase land, to hold or transfer shares, or to be the director of a domestic company. In addition, transfers between local foreign residents usually attract a higher tax than transfers between local residents. While the issuance of licenses and concessions on the transfer tax are reportedly fairly common, these still incur costs and time delays for investors. The general intention of the land licenses is to deal with the problems of land price speculation and reduction in the access of land to low or middle-income residents. However, it is not clear that alien landholding regulations are the most effective mechanism to achieve this goal.

4.59 Outdated investment codes in some countries create a level of policy uncertainty for the private sector as to whether certain elements will be enforced or not depending on government discretion. **One of the possible areas for policy reform is the updating and harmonization of member countries' investment codes that provide a comprehensive position of the sub-**

region's attitude and approach toward foreign direct investment and the provisions of its more unified investment regime.

4. 60 **Although administrative efficiency is not generally thought of as an area of strength for the OECS public sectors, firms interviewed and surveyed for this study did not raise it as a critical issue.** Indeed in a comparison of performance of key areas of the investment climate, foreign investors in Grenada had a more positive view of government efficiency than investors in Jamaica, Barbados, Dominican Republic and Trinidad and Tobago (see Figure 4.4). In Grenada, the majority of the private firms have a fairly positive view of government efficiency, and the consistency and predictability of the officials' interpretation of rules. Regulations regarding the establishment of new firms, such as business registration, licenses and permits, are not considered a big problem by most of the surveyed companies. Procedures for access to land and buildings, however, can take a long time and are rated more problematic. But overall, they are still considered quite manageable.

FIGURE 4.4: FOREIGN INVESTORS' PERCEPTIONS OF THE INVESTMENT CLIMATE



Importance rating for all investors surveyed: 3=moderate importance, 4=major importance, 5=critical importance.

Performance rating: 3=neutral, 4=good, 5=excellent.

Source: World Bank (2004a).

4. 61 **There were two notable exceptions – tax and customs administration. Throughout the OECS tax administration is cumbersome and often non-transparent.** Few revenue authorities have sufficient capacity to effectively monitor taxpayers, much less offer taxpayer services that can ease the administrative burden for businesses. In most countries, the tax administration's powers, taxpayers' rights, penalties and interest provisions are dispersed in several tax acts, and it is hard to get an up-to-date version of the tax laws including all amendments. This creates confusion, hinders compliance and facilitates evasion. Notably on the

incidence of tax payments, the survey in Grenada revealed that half of the business establishments were exempt from, or otherwise evading, the corporate income and consumption taxes in the previous 12 months. Few revenue authorities have specific arrangements for dealing with large taxpayers. Simplification of the complex tax system and investment incentives regime (along the lines discussed in the previous section) could contribute significantly to reduce these problems. In addition, both the recent IMF study on taxation administration in the OECS and the work of the sub-regional Tax Reform and Administration Commission (2004) have recommended the establishment of a regional tax authority as a way of more effectively utilizing the limited capacity across the member countries.

TABLE 4.4: FIRM RESPONSES TO ADMINISTRATIVE PROCEDURES IN GRENADA

| % of respondents who rate the issues as: | No Problem | A Minor/ Moderate Obstacle | A Major/ Severe Obstacle |
|---|-------------------|-----------------------------------|---------------------------------|
| <i>Entry procedures</i> | | | |
| Business registration | 83.1 | 13.4 | 1.5 |
| Business licensing | 77.1 | 17.4 | 3.0 |
| Proc. for access to land & premises | 67.7 | 20.9 | 9.0 |
| Proc. for utility hook-up | 63.2 | 29.4 | 5.5 |
| <i>Operating procedures</i> | | | |
| Business inspections | 77.6 | 17.4 | 2.5 |
| Fire, safety and sanitary regulation | 74.6 | 17.9 | 5.5 |
| Labor regulation | 61.7 | 26.4 | 10.0 |
| Tax administration | 59.7 | 31.3 | 7.0 |
| Customs regulation | 39.8 | 40.8 | 16.9 |
| <i>Other procedures</i> | | | |
| Patent and trademark reg. | 81.1 | 14.4 | 1.5 |
| Competition regulation | 76.6 | 13.4 | 7.5 |
| Foreign exchange regulation | 74.1 | 19.9 | 4.0 |
| Price regulation | 68.7 | 20.4 | 9.0 |
| Standards and certification | 66.7 | 22.9 | 8.5 |

Source: World Bank (2004e).

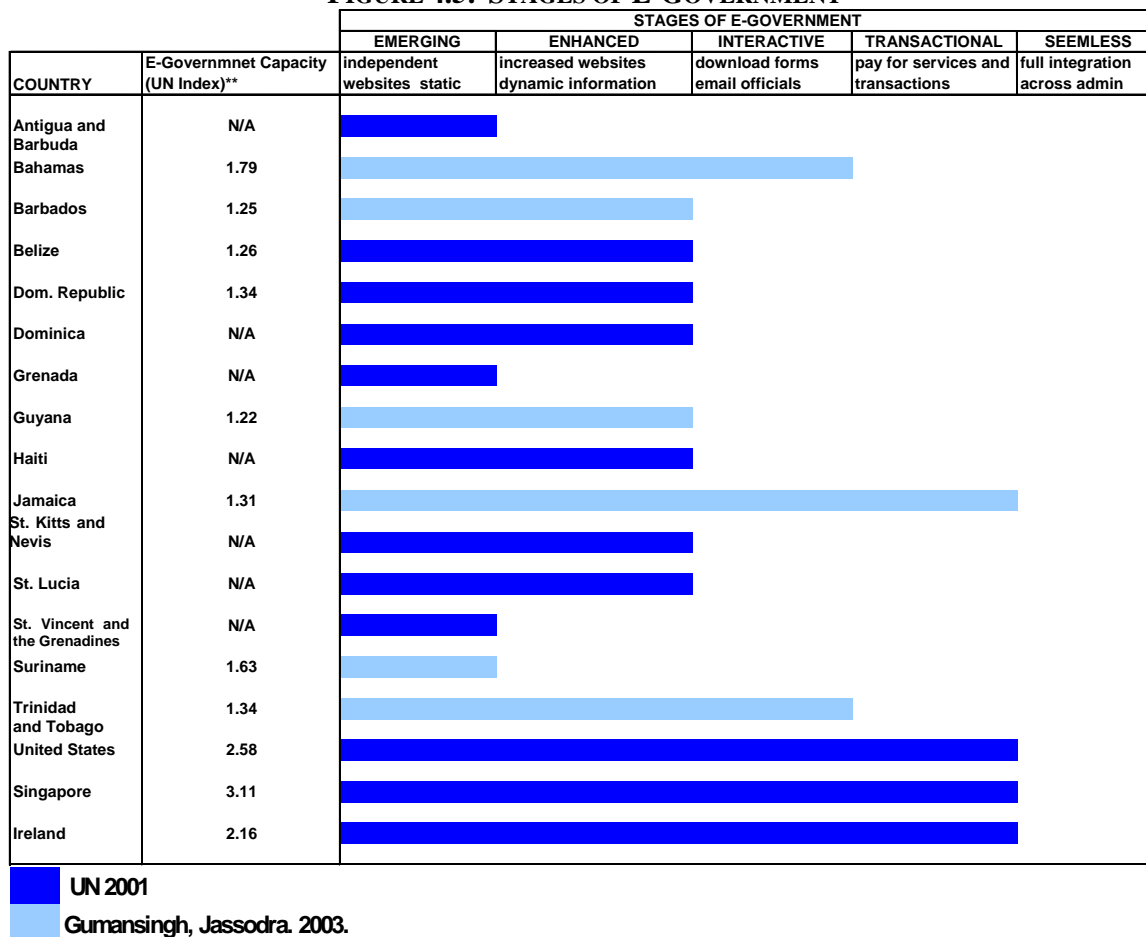
4. 62 **Among all government regulations that affect business operations, by far the most serious constraint is customs regulations.** In Grenada, firms report a median duration time of four days to clear imports, despite the small volumes involved. Manual and lengthy procedures, inefficient approach to inspection, use of reference prices for valuation (which is not WTO compliant) and an inadequate breakout of the classification system for goods contribute to these delays. The system is further complicated by the plethora of concessions that are granted. Rarely is the customs department fully informed of all the recipients and the duration of the concessions. A large part of the declaration process is then spent verifying the claims of importers. Notably, payment of bribes appears to be fairly unusual, but not completely nonexistent, and is generally associated with expediting process rather than tax avoidance.

4. 63 **Many of the OECS countries are trying to reform their customs services, but few have had significant success in part because of the incentive structure facing customs departments.** Given the countries' reliance on trade taxes, the fiscal imperative to raise revenues, and the widespread use of concessions, customs departments are generally not oriented toward trade facilitation. However, because of the reliance on imports throughout the whole productive structure of the economies, these time-consuming and costly procedures are a significant barrier to improving competitiveness. For example, one Antiguan manufacturer cites a two-week delay to clear a shipment of raw materials through customs, which reduced his manufacturing time by more than half and jeopardized a significant export order.

4. 64 **With both customs and tax administration, e-government can provide an important mechanism to improve service, increase transparency and promote technological development.** Systems such as the Automated System for Customs Data (ASYCUDA) and Standard Integrated Government Tax Administration System (SIGTAS) already in place have the potential to improve the collection of data, speed of transactions and completeness of information. There are numerous examples around the world in which countries have

revolutionized both their tax and customs administrations resulting in improved compliance, reduced cost of doing business and raised collections in return. Moreover, implementing e-government can provide a strong impetus to private businesses to upgrade their own systems in order to take advantage of the new way of doing business. Figure 4.5 below shows the different levels of e-government which have been achieved by various Caribbean governments to date.

FIGURE 4.5: STAGES OF E-GOVERNMENT



Source: InfoDev (2005).

4. 65 In implementing such systems, however, two considerations are worth noting for the OECS. **The first is that the cost of these systems, as recently shown by the Caribbean Regional Technical Assistance Center (CARTAC) for ASYCUDA, may be prohibitively expensive for small administrations such as are found in the OECS.** As such, a sub-regional effort for automating customs and tax administrations may be the best way forward. In this regard, CARTAC is undertaking a feasibility study of such a system.

4. 66 **The second consideration is that simply introducing the system without changing the underlying rules will limit its potential to improve the business climate.** Public sector administration in the OECS is fraught with multiple layers of approval that delay and obfuscate what are normally simple, rules-based administrative processes. For example, in Antigua and Barbuda the Minister of Labor must sign every work permit application leading to long time delays for investors. As illustrated above by the discussion on both procurement and investment promotion, these layers of approval often do not add to the quality of the decision-making, and

often provide opportunities for patronage. **Introducing e-government provides an opportunity for administrative reform in the processes and procedures that would further enhance the business climate.**