

## EXECUTIVE SUMMARY

1. The Organization of Eastern Caribbean States (OECS)<sup>1</sup> is at an economic crossroads. A secular slowdown in growth, a radical transformation of the external environment, high debt and fiscal imbalances, and persistent unemployment and poverty have combined to create an imperative for redefining the OECS strategy for growth and economic development.
2. The crucial elements of such a strategy are: (i) the formulation of a long-term vision that positions the OECS Economic Union in the global economy; (ii) reorientation of the basic development model toward greater openness, competition and a more level playing field in the sub-regional economy, and (iii) the creation of new capacity in the labor force and the private sector to take advantage of emerging opportunities in the global market place, and in the public sector to coordinate and support the process of deeper regional (and global) integration.
3. This strategy builds on the assumption that a more complete Economic Union, based on deeper sub-regional integration, is not only a *sine qua non* for the member countries to successfully face their development challenges, but that this approach has already been endorsed both by the Governments and people of the OECS:

*“The rationale for the establishment of an economic union is anchored in an acceptance of the fact that the development challenges the micro- states of the OECS face as a result of globalization and trade liberalization can only be effectively addressed through the creation of a single economic space which facilitates the free movement of people, goods, services and capital and as a result economic diversification and growth, greater export competitiveness and more employment and human resource development.”*  
<http://www.oecs.org/union.htm>

4. As discussed in Chapter 1, the OECS sub-region experienced a relatively strong decade of growth in the 1980s (5.9 percent per year) driven mainly by tourism and banana exports, and public investment financed primarily by development assistance. This was followed by a steady decline in growth since the early 1990s. Initially, this decline was largely caused by a sharp reduction in productivity growth associated with shifts in the composition of investment, weakening performance in the export sector and a growing inward orientation of the private sector. It has been further exacerbated by a severe and prolonged contraction in private investment. In the late 1990s, attempts by the OECS governments to offset the slowdown through an expansionary fiscal policy, financed largely by expensive commercial borrowing (both external and domestic) created persistent fiscal deficits and skyrocketed public sector debt to some of the highest levels in the world. The large fiscal and debt imbalances are now further dampening growth and private investment.
5. The current challenge facing the sub-region is how to reinvigorate and sustain growth alongside the following imperatives – reducing high unemployment and poverty rates, restoring fiscal and debt sustainability, and securing a more sustainable external position in an increasingly competitive global environment. Accelerating growth in the OECS will largely depend on the

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<sup>1</sup> The OECS comprises six independent members states: Antigua and Barbuda, the Commonwealth of Dominica, Grenada, the Federation of St. Christopher and Nevis, St. Lucia, and St. Vincent and the Grenadines (all members of the World Bank Group) and three British dependencies: Montserrat, Anguilla and the British Virgin Islands. In this report, the term “OECS” has been used, generally, to refer to the six independent countries.

sub-region's ability to strengthen its performance in the global economy, which in turn will require improving its competitiveness. At the macro level, competitiveness can be defined as an economy's ability to attract the demand for its exports and the investment to supply that demand, all within social norms that result in an improved standard of living for its citizens. This, in turn, depends on the macro- and micro-economic policies, regulations and institutions that affect the productivity of the economy's factors of production and the costs of doing business.

6. Chapter 2 of the report looks at the key measures of macroeconomic competitiveness, the real exchange rate, export performance and Foreign Direct Investment (FDI) inflows. Trends in the real exchange rate<sup>2</sup> show that, in the latter half of the 1990s, the OECS economies demonstrated a growing inward, rather than external, orientation, and a general loss of price competitiveness. However, owing to a recent realignment driven mainly by external developments (notably the weakening of the US dollar), by mid 2003 the real exchange rate did not appear to be either over- or under-valued with respect to key fundamentals. There is also some indication that real wages have grown faster than labor productivity further weakening the price competitiveness of the sub-region (Chapter 6).

7. Since the 1990s, the sub-region's key export, tourism, has lost market share in the Caribbean and worldwide, while key merchandise exports, including but not limited to the traditional agricultural products, have contracted or seen only marginal growth. Indeed, most of the diversification in regional merchandise exports to date has been driven by preferential access to regional and North American markets. Invariably these preferences have not been directed to areas of comparative advantage on which the sub-region can hope to build sustainable sources of competitive advantage. The majority of the top ten exports from the sub-region are still commodity based – fish, nutmeg, essential oils, arrowroot – and are subject to large price and other variations, e.g. climate. Others are goods in which competitive production depends on low wages or significant economies of scale, neither of which the sub-region can sustain. There are some indications that the OECS is in the process of identifying new exports – both of goods and services — but these are still too small to impact macroeconomic performance.

8. In contrast to exports, the OECS has been extremely competitive in attracting foreign investment, with relatively stable flows as a share of Gross Domestic Product (GDP) through the last two decades. The average ranking of the OECS as a whole on the UNCTAD's FDI performance index in 2002 was 20th out of 177 countries. However, in comparison to the Caribbean and the rest of the world, the sub-region has been losing ground in recent years. A closer look reveals that extensive use of statutory and discretionary fiscal incentives, often fueled by incentives-based competition for FDI, both in the sub-region and Caribbean wide, have played a key role in this performance. This issue is further explored in Chapter 4.

9. As illustrated in Chapter 3, reliance on special and differential treatment as a way of relating to the world economy has not served the sub-region well, over the long term. Preferences and the maintenance of non-reciprocal protection of the domestic market have pushed the sub-region, and its entrepreneurs, toward areas of production in which they ultimately can not be competitive and which can not support the sustained growth in incomes and employment needed to reduce poverty and deepen social development. Non-reciprocal protection within the various trade agreements with the European Union (EU), Canada and the US has allowed the sub-region to stall on trade liberalization, maintaining a relatively high level of effective protection of the domestic market which is, ultimately, too small to sustain growth. This protection has engendered a growing inward orientation of the private sector whose efforts are spent trying to

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<sup>2</sup> IMF (2004c).

maintain rents for a few local producers at the expense of consumers and export sectors, whose costs are then raised above world prices. Governments have then turned to accommodate the export sectors with an administratively cumbersome and nontransparent system of duty concessions, which in turn are negatively affecting fiscal performance. Meanwhile, managing the conflicting interests in such a system has distracted the sub-region's governments from making headway in improving the general environment for the business sector and resulted in a slowdown in private investment. In summary, the sub-region appears to have reached the limits of growth under the current model of development.

10. The emerging external trading environment, with the Caribbean Single Market Economy (CSME), Free Trade Area of Americas (FTAA) and WTO offers opportunities to the sub-region to transform the current model of development to a more sustainable one in which it is integrated within larger markets and ultimately the global economy (Chapter 3). Among the micro states, the OECS countries have a unique opportunity for success because of their proximity and affinity to major markets in Europe and the Americas, and a headstart on integration within the sub-region and the Caribbean. In addition, the OECS experience to date with tourism, internet gaming and offshore education points to the potential for expanding other service exports (Chapter 7).

11. Through the FTAA, there is the potential to make headway in liberalizing trade in services, now the fastest growing component of world trade in the last 14 years and accounting for one-fifth of exports of goods and services worldwide and half of annual FDI flows. Under the EPA, the sub-region will receive substantial assistance to mitigate the costs of transition. How the sub-region uses these resources will be a critical factor for success. The rules-based WTO system has already shown, through the recent victory of Antigua and Barbuda over the US on internet gaming, that it can protect the rights of small states. Finally through the CSME, the OECS stands to gain from several areas of regional cooperation, including empowered joint regional negotiating mechanisms and the preparation of a host of behind-the-border rules, including standards, licensing, and competition rules, that can ensure fair trade in services and strengthen the ability of domestic firms to compete.

12. Much has been written about the challenges faced by small states in this endeavor but, on close examination, the OECS countries appear to have overcome a number of these, and are among a handful of micro states, and a larger group of small states that have performed relatively well over time, on economic, external and social fronts. The sub-region has demonstrated resilience to both natural disasters and external shocks. Cooperation at the sub-regional level has already helped to reduce the fixed cost of some public services, and has significant potential to do so in many others. The sub-region is strategically located at the center of a large regional market and still has some scope for cooperation to reduce transportation costs. In today's world the scarcity of physical resources that comes with small size is no longer a major constraint on diversification. The acquisition of knowledge and technology, which are less susceptible to economies of scale and distance, are key factors in today's economy.

13. As such, the outlook for the OECS in the global economy need not be a pessimistic one. There are instructive examples of other small states that have successfully integrated with the global economy. Though not a micro state, Ireland had many of the initial conditions facing the OECS today and has been extremely successful in carving out a place for itself within the European Union (EU) and the world economy. This case study is presented in Chapter 3. Of note is the fact that the first step on Ireland's road to reform was a major and rapid fiscal adjustment over three years, which was achieved on the basis of a broad social pact including the

wider population, private sector, labor unions and other civil society stakeholders. Given the transition ahead, such a pact may be an appropriate strategy for the OECS.

14. As illustrated in the sectoral case studies presented in Chapter 7, taking advantage of this potential will require a host of general improvements in the business environment, namely strengthening the investment climate (Chapter 4), expanding the skills base (Chapter 5), promoting innovation and technology adoption, and improving teleconnectivity, international transport services and electricity supply (Chapter 6).

15. As shown in Chapter 4, the size and role of government in the OECS has a profound impact on the climate for domestic and foreign investment. The government sector in the sub-region is relatively large, as is typical in small open states, but it has also been consistently growing in employment and spending as well. Experience in the wider Caribbean in the 1960s and 1970s, and in the OECS during the last two decades, confirms the dangers of an over-reaching public sector and limitations of public sector-led growth. Given the current fiscal imbalances and high levels of indebtedness, the sub-region has little room for maneuver and will need to embark on a sustained process of fiscal adjustment and public sector reform.

16. Fiscal adjustment will also be required in the OECS in order to improve the climate for private investment by helping to reestablish macroeconomic stability and relieve pressures on the domestic financial system. A key element of this reform will be to streamline and refocus large public investment programs, which have contributed to the increasing indebtedness but not succeeded in crowding in private investment, in large part because of the lack of a strategic vision of where the economy is headed. There are numerous examples of large public investments that have cost the sub-region dearly in fiscal terms, but not yielded sustainable economic gains. In this regard, reform of public procurement systems can not only achieve cost reduction for the public sector but also improve competition in the private sector, and reform of legislation and systems governing public debt can help to prevent future recurrences of costly financing.

17. Efforts to strengthen the investment climate, in particular by rationalizing the investment regime and improving the delivery of key government services, will also be critical. The incentive regime, used by the OECS governments to compete for foreign investment is outdated, ill-suited to emerging service sectors and costly both to administer and in terms of foregone revenue. In addition, the sub-region has further discouraged competition in the domestic market with the continued use of price and investment controls. These have combined to distort the playing field among domestic and foreign investors alike. International experience, in particular in Mauritius and Ireland, suggests that lowering tax rates and concentrating on other means of investment promotion may be more effective than an unwieldy collection of concessions and controls.

18. To complement the rationalization of the investment regime, the sub-region will also have to strengthen its approach to investment promotion, which given the past reliance on incentives, remains in its infancy. Little attention has been given to key functions such as image building, and investment targeting and facilitation, in part because of the absence of a strategic vision for the economy in which the role of FDI is clearly identified. There also are significant savings to be made in eliminating layers of approval and discretion in a variety of government services — such as land and business registrations, work permit processing, customs administration — that will also improve the general investment climate. Making headway on e-government initiatives is one way to accomplish these multiple goals. Two key administrative areas cited by firms for improvement are tax and customs collection in which administrative weaknesses combine with cumbersome and non-transparent regimes to create obstacles for investors. By simplifying the

tariff regime and tax code, the sub-region has the dual opportunity to broaden the tax base and to strengthen the investment climate by rationalizing the incentive and concessions regimes and creating a more level playing field for investors and domestic firms.

19. As discussed in Chapter 5, the most critical constraint facing businesses in the OECS is the limited skills base of the labor force. In addition, moving to higher-end services will require a larger number of skilled workers. The shortage of skills is the result of inadequate educational outcomes, and limited tertiary education and training opportunities. The OECS has made remarkable progress in expanding access to secondary education over the last decades, but quality and equity remain critical weaknesses. Indeed these issues are the main contributors to the very high youth unemployment rates which are now creating social problems. Though comparatively high, public expenditures on education in the OECS are fraught with inefficiencies that result in poor quality and inequitable outcomes. Fortunately, the measures to address them, such as rationalizing teacher training and deployment schemes, shifting resources to better performing schools and reforming the secondary school curriculum, are neither complex nor prohibitively expensive.

20. The shortage of tertiary education and training opportunities is more difficult to tackle given the small scale of the domestic and sub-regional markets. At a minimum, the OECS countries could increase cost recovery and involve the private sector in the governance of public training institutions to ensure that the skills being provided are relevant to labor market needs, and could promote spillovers from local offshore education institutions to the domestic market, following the example of St. George's University in Grenada. Tertiary education and training are two areas where expanding the labor market space of the OECS to the broader Caribbean can serve the sub-region in two critical ways. First, a large market space may allow external training providers who are achieving economies of scale in other markets the opportunity to expand services to the OECS. Second, greater freedom of movement and wider opportunities for employment will also provide OECS nationals with a stronger incentives to be trained in specific technical skills. To support this, the OECS should ensure that the accreditations and certifications that it supports are internationally portable.

21. An effectively functioning labor market is a necessary complement to ensure that the expanding supply of skilled labor is efficiently allocated. Comparatively high wages that appear to be growing faster than productivity, accompanied by persistently high unemployment, suggest that labor markets in the OECS may not be functioning efficiently. Both problems impact competitiveness negatively – high wages because they raise the cost of production and unemployment because it wastes a crucial factor of production. There are a number of imperfections in the OECS labor market that prevent smooth adjustments, in particular skills mismatch, large and expanding government sector, distinct wage-setting mechanisms for the public and private sectors, labor regulations that raise the cost of hiring and firing workers, fragmentation of the sub-regional labor market, and significant migration flows.

22. The major challenge facing the OECS is to equip the large numbers of un- or under-employed with the skills required by growing sectors. In addition, public sector reform to reduce crowding out in the labor market and aligning public sector wage setting mechanisms with those for the private sector will also be critical. Disparities in wage rates and regulatory barriers to movement of labor across the OECS indicate that the sub-regional labor market is far from seamless. However, efforts to reduce the size of government and increase the flexibility of employment arrangements are likely to generate strong opposition from trade unions and workers in protected sectors. Successful experiences in Ireland, Barbados and Jamaica with social pacts may thus need to be replicated in the sub-region.

23. The OECS has seen significant migration of skilled personnel beyond the region over the past two decades, but it has also benefited and stands to benefit from remittances and return migrants that transfer skills and technology, as well as investment capital, and overseas migrants who have created the demand and awareness for home country exports. Migration opportunities have generated an additional demand for education with spillovers to the local economy, but they have also raised reservation wages and led to queuing where workers delay entry into the labor force as they wait for overseas jobs. Greater integration of the sub-regional and regional labor markets will reduce the frictional impact of migration – as the markets are more integrated, workers can move more easily and wages become more aligned across countries. As such, the OECS should push for rapid implementation of free movement of labor in the sub-region and under the CSME and reduce as much as possible regulatory constraints to the flow of workers.

24. If the OECS is going to pursue a private sector-led, export-oriented growth strategy, local firms accustomed to a protected domestic market will have to improve their capacity to compete globally. At the firm level, innovation is the key to building and maintaining competitive advantage. Chapter 6 showcases some examples of innovative firms that are already changing the landscape of the business sector in the sub-region (and in the Caribbean) using ICT as a means to compete in the international market place. The chapter also reviews some of the mechanisms for building private sector capacity and for strengthening the general environment for innovation and technology adoption. One finding is that this too is dependent on the free movement of labor, because it will allow firms to access services from private providers who may not necessarily have enough business to establish shop in any one of the OECS countries. In addition, there is a crucial role for governments in setting the standards against which firms can measure their performance, and helping to coordinate clusters of operators in similar fields across the sub-region.

25. The recent successes of sub-regional institutions, namely the Eastern Caribbean Telecommunications Authority (in expanding teledensity, competition and cost reduction) and the Directorate of Civil Aviation (in addressing security issues in the sub-region's airports) provide examples of how to move forward on a number of technical infrastructure issues facing the OECS. Although costs of teleconnectivity are high, in particular for commercial (broadband) access and international telephone calls, and access to the internet is rather limited, the Eastern Caribbean Telecommunications Authority (ECTEL) offers a proven mechanism for the sub-region to address these issues. Regarding the expensive and, sometimes, unreliable supply of electricity – cited as a key problem by many firms – this report finds that the root cause is not so much the small scale of operations as often suggested, but, in fact, weak regulatory oversight. Given the technical nature of this issue and the limited capacity of member country governments, a regional approach, similar to ECTEL, offers significant advantages. Regional solutions also offer the possibility of depoliticizing pricing issues in critical utility services. As small island economies, transportation remains a critical factor of production, but also one in which sub-regional coordination is critical. Given the serial (versus spoke and hub) pattern of shipping services to the sub-region, new international security arrangements require each port in the queue to be “certified”. Finally, on aviation, the report finds that the sub-region stands to gain from joint negotiation on international airline service, and from formulation on intra-regional aviation competition policy.

### **Overarching Strategic Agenda**

26. The foregoing analysis suggests the following strategic agenda:

**(i) Formulate a strategic sub-regional vision for the economy and key sectors**

27. In looking at the past development of the OECS, which largely depended on tourism, donor-financed public investment and preferential market access for inherited commodities, there is a sense that this was not driven by a vision prepared and owned by the people of the sub-region. The recently agreed upon OECS Development Charter has taken this process forward in terms of a regional view of broad developmental aspirations. The strategy for reaching those goals needs now to be more carefully specified in view of the opportunities and constraints facing the sub-region. It is the recommendation of this report that such a strategy acknowledge the limitations of small domestic markets to provide sustainable growth in incomes, and focus heavily on articulating a vision of the position the OECS hopes to occupy in the global economy.

28. As noted above, and throughout this report, deepening integration through the completion of the OECS Economic Union will be a critical step to strengthening competitiveness of the sub-region. Unifying factor markets across the sub-region will allow for more efficient allocation of capital, labor and entrepreneurship in order to achieve success in more competitive product markets. In addition, closer collaboration between the governments on regulation, trade negotiations, and provision of public services, to name a few areas, can help to conserve limited fiscal resources and capacity while improving the effectiveness of the public sector.

29. Most of the smaller states that have successfully integrated in the global economy, Singapore, Israel, Iceland and Ireland, to name a few, have articulated such a vision at one time or another. One option, but by no means the only one, could be for the sub-region to capitalize on its strategic location and its tourism sector to move into a cluster of mode 2 type services in education, health and wellness, financial services and entertainment. The articulation of such a strategy and vision is necessary for effective negotiation in trade arrangements, effective planning of public investment and formulation of public policies and better use of aid flows.

30. As illustrated in the case on Ireland, to be viable and sustainable, such a vision must be articulated by and with the broader society, the private sector and key civil society organizations.

**(ii) Pursue greater openness, competition and a more level playing field in the domestic market**

• **Reduce barriers to trade and improve the mobility of labor and capital by:**

- Undertaking tax reform to make fiscal space for a reduction in taxes on trade. Countries should move quickly to implement broad based taxes such as the Value Added Tax (VAT), and in some cases, personal income tax, in order to provide fiscal room for the reduction in tariffs, customs service charges and other taxes on international trade;
- Phasing out exceptions within the Common External Tariff (CET) and eliminate non-trade barriers including licences and quotas. Gradual reductions in tariffs will not only provide a bargaining chip for trade negotiations but also create both the incentive and transition time for firms to reorient their activities toward the external market;
- Reducing and reforming the use of duty concessions. Reducing tariff rates and non-trade barriers will also reduce the need for widespread use of duty concessions and related costly and cumbersome administration;

- Rapidly implementing free movement of labor within the OECS and the CSME. Access to a greater pool of skills is a key to raising firm capacity. Wider opportunities for employment within the region create the demand for training and tertiary education, and a large market space for key service providers;
  - Pushing for critical market access in FTAA to facilitate service exports. This will not only help professionals from the OECS to market their services overseas, but may encourage service providers, such as training institutions, that benefit from economies of scale in other countries, to provide services in the OECS markets; and
  - Utilizing already-recognized international standards and certifications wherever possible, or where location-specific certifications will help to create a competitive advantage, work jointly with the Caribbean Community (CARICOM) to prepare and implement these.
- **Promote fair competition and a more level playing field in the domestic market by:**
    - Reducing the burden of government on the market for skills and investment resources by pursuing fiscal adjustment and public sector reform;
    - Reforming the tax and customs regime to reducing the need for and use of investment incentives and discretionary duty concessions;
    - Strengthening public procurement by harmonizing systems across the region to conserve limited technical capacity. This will help to increase competition in the domestic market, prevent capture by local firms, improve accountability, and ultimately, reduce the costs of public goods and services;
    - Re-establishing rules-based administration by eliminating unnecessary layers of approval and discretion in the administration of registrations, permits and licenses administration;
    - Reforming the public sector wage setting mechanism to align wage increases with productivity improvements;
    - Harmonizing labor regulations for both the public and private sector in order to reduce labor market segmentation;
    - Improving the functioning of the financial markets to reduce the costs of borrowing by reducing administrative bottlenecks to the realization of collateral; eliminating floor on the savings deposit rate; and encouraging consolidation in the banking sector as a means to reduce operating costs and spreads; and
    - Formulate a competition policy for the intra-regional airline market.
- (iii) **Building new capacity in the labor force, private sector and government by:**
- **Improving efficiency of education spending**
    - Reform teacher training and deployment schemes to make room for an increase in non-wage spending in the education sector;
    - Reallocate spending to more needy schools in order to improve equity, address the growing problem of youth-at-risk and reduce labor market segmentation;

- Improve monitoring and international benchmarking of, and public information on, educational outcomes to increase accountability; and
- Implement cost recovery in tertiary education and training and improve targeting of student assistance and loan programs.
- **Refocus curricula in schools and training institutions on labor market needs**
  - Expand skills training in IT, hospitality, non-hotel tourism services, accounting, finance and management;
  - Target vocational training on linkages with export sectors rather than solely microenterprise skills for the domestic market;
  - Implement the Caribbean Knowledge and Learning Network and other distance learning efforts; and
  - Establish a key role for the private sector in the governance of public education and training institutions and programs.
- **Expand use of standards and certifications in the business sector** to provide an incentive for improving firm capacity, e.g.,
  - Strengthen accounting standards and practices; and
  - Expand tourism standards and certifications to include non-hotel services.
- **Publicly reward innovation, entrepreneurship and private sector formation of industry clusters**
- **Improve the delivery of public services, in part through joint sub-regional provision and harmonized regulations, wherever possible**
  - a. Reform and refocus public investment programs;
  - b. Refocus investment and tourism promotion away from incentives administration to image building, investment facilitation services, destination management and marketing, and coordination;
  - c. Strengthen regulatory frameworks for telecom, electricity, and maritime transport through regional cooperation;
  - d. Strengthen management of the environment to ensure sustainable tourism development;
  - e. Strengthen participation in CSME and FTAA negotiations, through an empowered Caribbean Regional Negotiating Machinery (CRNM), supported by the recently proposed sub-regional mechanism; and
  - f. Introduce e-government as a mechanism to improve transparency and enhance service delivery, as well as to streamline the public sector.

31. No doubt this is a daunting agenda, both broad and deep. But the transformation envisaged here is fundamental for the OECS countries. It will require the concerted effort on the part of the OECS governments, including the sub-regional institutions, the private sector and civil society, as

well as sustained support from its development partners, over a medium-term horizon. Hence the need for broad-based participation in the formulation of the strategic vision.

### **Recommended Short-Term Priorities**

32. Given the limited capacity of the public sector to address all the recommendations at once, the following is a proposal for some **immediate priorities**, which can be addressed over the short term.

#### **Fiscal and public sector reform**

- Roll out VAT and reform the investment incentives regime;
- Initiate public sector reform and refocus the public investment programs; and
- Remove non-tariff barriers to trade.

#### **Raise the skills base**

- Reform teacher training and deployment schemes; and
- Accelerate curricula reform in schools and training institutions.

#### **Strengthen the enabling environment**

- Update tourism strategy to target new market segments;
- Strengthen investment and tourism promotion; and
- Strengthen and harmonize accreditation for offshore schools.

#### **Improve the business environment**

- Streamline customs administration;
- Address monopoly pricing in remaining telecom segments;
- Improve oversight of electricity utilities to reduce costs;
- Formulate and implement an aviation competition policy; and
- Reform petroleum pricing mechanisms.