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A Project on Caribbean Economic Governance

## Fostering Growth and Development in Small States through Disruptive Change: A Case Study of the Caribbean

AVINASH D. PERSAUD



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## About the Caribbean Economic Governance Project

This project convened researchers and leaders within the private and public sectors to examine and provide substantive answers and policy prescriptions to current economic governance challenges facing the Caribbean region. The papers were initially presented at CIGI workshops, where the authors benefited from extensive comments and discussion on their work. This series presents and discusses policy issues pertaining to trade, investment, human capital, the fiscal outlook, public sector management practices and other issues relevant to the Caribbean region's economic future.

CIGI's Caribbean Economic Governance Project is directed by Daniel Schwanen.

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## Summary

The desks of civil servants in small states are stacked with yellowing consultancy reports from multilateral agencies on the need to generate sustainable jobs and growth, attract investment, bolster infrastructure and institutions, and improve the efficiency and reduce the expense of government. The real question is not what, but why? Why, in spite of everything we know, are many small states, especially those in the Caribbean, trapped in a zone of low growth, stagnation or relative decline? Policy makers face physical and financial constraints and implementation deficiencies, but the overriding constraint, even more so than in other countries, is political economy.

The economic framework shapes the political structure, making it difficult for governments to reshape the economic structure. State employment tends to be high, and few political parties will risk the wrath of public sector workers. Enterprises that benefit most from special preferences are the major benefactors to social initiatives. New and radical initiatives to transform a country can find no sponsors other than incumbents afraid of change. An inefficient public sector benefits “insiders” — those middle and upper classes with connections — versus “outsiders.”

Too many choices can add to the procrastination and obfuscation. One advantage of small island states is that their economic constraints present only a limited number of development path choices. Where overseas markets are large and local markets small, there are few options to an outward orientation and a focus on professional services such as legal, accounting, diagnostic and financial, and exporting specialty manufacturing and agricultural products — for example, aged rums, specialty sugars, rare coffees and fresh fish. There are not many alternatives to exporting “weightless” products, where a large proportion of the value is in the marketing and design, when markets are distant and overseas. In small states where capital is tightly held and there is a plantation legacy, it is important to encourage existing businesses to expand both regionally and globally, creating economic and political space to improve competitiveness at home by facilitating entrepreneurship and access to capital. Investment in the preservation and enrichment of the natural, built and social environments is critical when countries are physically small.

The region is showing dangerous signs of sinking under the weight of excessive introspection — the real debate concerns how to enable change in these directions. The

Caribbean is not globally competitive, but dependent. The cost of living is high, ratcheted up by inefficient ports, monopolistic transport markets, high fees and taxes. The appearance of “openness” in trade and finance hides protectionism. Stock markets and capital markets are generally moribund, and with the recession and extra vulnerability to shocks leading to high debt levels, private investment is, by and large, crowded out. Now that the rest of the emerging world has shaken off excessive political uncertainty and illiberalism, the much-vaunted stability of the Caribbean is viewed more as a disadvantage, rather than a platform for growth. The downward trajectory of growth in the Caribbean over the past 20 years has been reinforced by high emigration rates among the highly educated and talented.

The current situation in the Caribbean suits the people with influence. The political economy constraint to the governance and modernization of small states is, perhaps, the single most important argument for greater regional integration. Exhortations for change and new reports from consultants will be warmly received and promptly ignored.

In contemplating enduring, sustainable change, those changes that have the potential for disruption, not in a willful sense, but as a source of innovation, need to be the priority. Too many of the existing instruments and strategies — grand construction projects, new university centres and buildings, and renewable energy projects with strategic business partners — necessarily favour and reinforce the established order and keep the channels of influence and payments well lubricated. This means

thinking as much about incentives as institutions. It means focusing on enabling outcomes rather than betting on single, big, prescriptive solutions. In the English-speaking Caribbean, hosting the 2007 Cricket World Cup, with the associated large investments in stadia and port infrastructure, was meant to be a catalyst for development, but most of these aspirations appear unfulfilled.

The critical instruments of disruptive change are technology, finance, business facilitation and competition. Critical strategies for governments include:

- Exploiting technology;
- Reorganizing the delivery of public services to place the citizen/consumer at the centre of allocation decisions;
- Nudging the establishment of new organizations of capital — without providing much capital; and
- Taking a more aggressive stance to regional trade and national competition policy.

Although there are numerous reasons to be pessimistic about the future of the Caribbean, there are also many reasons to be optimistic: the region boasts tremendous resilience and creativity, and has one benefit of size — small states can make changes that will have impact in a relatively short space of time. The world’s successful small states, such as Singapore, Hong Kong, Bermuda, Mauritius and Luxembourg, do not share geography or history, but they have all moved from near the bottom of the economic pile to the top in just one generation, something that is much harder for large states to contemplate.

## Author Biography

Avinash D. Persaud is emeritus professor at Gresham College, London; a senior fellow at London Business School; a visiting fellow at the Centre for Financial Analysis and Policy, Judge Institute, Cambridge University; 2010 president of the British Association for the Advancement of Science (Section F) and past governor of the London School of Economics and Political Science.

Mr. Persaud is currently chairman of Elara Capital PLC, an investment bank based in London and Mumbai; chairman of PBL, a real estate development company in the Caribbean; chairman of Intelligence Capital Limited, a London-based financial advisory firm; and board director

of RBC Latin America and the Caribbean. He was formerly a senior executive at J. P. Morgan, State Street and GAM Holdings. He is a senior adviser to the Financial Services Law Reform Commission in India, a member of the UK Treasury’s Audit Committee and a member of the National Council of Economic Advisors in Barbados.

Formerly, he was the chairman of the Warwick Commission on Financial Reform, the chairman of the regulatory sub-committee of the UN High-Level Task Force on Financial Reform, co-chair of the OECD EmNet and member of the Pew Task Force to the US Senate Banking Committee.

## Acronyms and Abbreviations

|         |  |
|---------|--|
| AML     | anti-money laundering                                  |
| CARICOM | Caribbean Community                                    |
| CCMF    | Caribbean Centre for Money and Finance                 |
| CCMS    | Caribbean Centre for Monetary Studies                  |
| CLICO   | Colonial Life Insurance Company                        |
| CMSE    | Caribbean Single Market and Economy                    |
| EPA     | Economic Partnership Agreement                         |
| EU      | European Union   |
| G20     | Group of Twenty  |
| ICT     | information communication technology                   |
| ICTA    | Imperial College of Tropical Agriculture               |
| IFCs    | international financial centres                        |
| IMF     | International Monetary Fund                            |
| ISI     | import-substituting industrialization                  |
| LNG     | liquefied natural gas                                  |
| NGC     | National Gas Company of Trinidad and Tobago            |
| OECD    | Organisation for Economic Co-operation and Development |
| OECS    | Organisation of Eastern Caribbean States               |
| PPP     | purchasing power parity                                |
| R&D     | research and development                               |
| RRC     | Regional Research Centre                               |
| UN      | United Nations   |
| US      | United States  |
| UWI     | University of the West Indies                          |
| VAT     | value-added tax  |

## Introduction

Compared with many regions of the world, the small states<sup>1</sup> surrounded by or bordering on the Caribbean Sea are blessed with a number of positives. The region, as a whole, is juxtaposed between two large, wealthy continental markets with a combined GDP of US\$21 trillion — significantly greater than the combined GDP of South Asia and East Asia.<sup>2</sup> It also boasts a pleasant climate and a beautiful physical environment, with tourism being the major industry in many of the nations, with beaches and hotels that are the most coveted in the world.

In the 18 states of the English-speaking Caribbean, the proportion of the population who live in abject poverty is generally modest.<sup>3</sup> Less than five percent of the population in Barbados, for example, lives beneath the poverty line.<sup>4</sup> For these states, poor public health is not a pressing weight on growth, and income inequality is not as extreme as in many continental neighbouring states to the south. The Gini-coefficients in these countries are among the lowest in Latin America and the Caribbean. Literacy is close to universal in many countries and very high in most others. One factor behind these positive social fundamentals is that public expenditure on education as a percentage of GDP is one of the highest in the developing world — averaging five percent in Caribbean Community (CARICOM) nations.<sup>5</sup>

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1 Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Guadeloupe, Grenada, Guyana, Haiti, Jamaica, Martinique, Montserrat, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, Trinidad and Tobago, Anguilla, British Virgin Islands, Cayman Islands, Turks and Caicos Islands, Aruba, Curaçao, Puerto Rico and Saint Maarten.

2 In purchasing power parity terms, the GDP of East Asia is \$11.8 trillion, South Asia is \$4.6 trillion and the European Union is \$14.4 trillion.

3 Outside the English-speaking Caribbean, Haiti and the Dominican Republic are burdened with very low GDP per capita and high levels of income and health inequality. In the aftermath of the devastating earthquake in January 2010, Haiti also suffered an outbreak of cholera, a disease practically unheard of in the rest of the region.

4 The lowest concentrations of poverty can be found in the Bahamas, Cayman Islands and Barbados. In contrast, 80 percent of Haiti's population lives below the poverty line.

5 CARICOM is an organization of 15 Caribbean nations and dependencies whose main purpose is to promote economic integration and cooperation among its members.

The region's creative output is remarkable for its size. The Caribbean boasts three Nobel Laureates,<sup>6</sup> and major genres of music originated in the region — reggae, dance hall, soca and calypso. There have been a large number of international superstars born in the Caribbean, both in the cultural and sporting arenas, including Bob and Ziggy Marley, Rihanna Fenty, Usain Bolt, Shaggy, Sean Paul, Wyclef Jean, Patrick Ewing, Sammy Sosa and Sir Garfield Sobers. The Caribbean diaspora maintains strong cultural and financial links with their home nations, contributing hard currency remittances that are a significant source of balance-of-payments support for some countries. Language is not a hindrance to international trade, with English and French being the main languages spoken. Many critical public institutions, from constitutional democracy and judicial independence to sanitation systems and hospitals, have a long tradition.<sup>7</sup> Political change is, mostly, democratic and peaceful.

The Caribbean should not, however, be viewed as a homogenous region. Even putting aside Cuba, with its Communist government since 1959, Puerto Rico with its special status with the United States (US) and Haiti, the poorest island, there are enormous differences within the region. The continental countries of Guyana, Suriname and Belize boast small populations inhabiting large expanses of well-watered and fertile land. Dominica, Grenada, Martinique, St. Lucia and St. Vincent — considered to be the “more volcanic” islands — are small and lush, with rivers and mountains. Anguilla, Antigua, Aruba, Bahamas, Barbados, Cayman Islands, Curacao, and Turks and Caicos — the mainly coral islands — are tiny, flat and water-poor, but blessed with world-renowned beaches and reefs. The larger islands of Jamaica and Trinidad and Tobago have significant manufacturing employment. Mineral resources make a substantial contribution to development in Trinidad and Tobago (oil and gas), Guyana (bauxite, gold and diamonds) and Jamaica (bauxite). The fishery and forestry industries are significant sectors of the economy for Guyana and Suriname. There are differences beyond resources and geography. Remittances are as much as 15 percent of gross national income in Jamaica and Guyana, but are below five percent in almost all other CARICOM countries. Per capita income is 10 times greater in Trinidad and Tobago than in neighbouring Guyana. Eighty percent of the population lives below the

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6 Sir Vidiadhar Surajprasad (V.S.) Naipaul, Derek Walcott and Sir Arthur Lewis.

7 The Barbados House of Assembly began meeting in 1639 and is the third-oldest legislative body in the Western Hemisphere, preceded only by the Bermuda legislature and the Virginia House of Burgesses. The Barbados Psychiatric Hospital has been on the same site since 1893.

poverty line in Haiti, and as noted previously, just five percent in Barbados.

The region as a whole has deep cultural and economic divisions. Two hundred and sixty years after the first Navigation Act,<sup>8</sup> trade, capital and labour continue to flow along the “fault lines” of language, both at the intra-region level and between the region vis-à-vis the rest of the world. These fault lines ignore geography and, instead, follow the haphazard settlements of seventeenth century squabbles among warring European empires.

Given these differences, drawing generalizations across this varied group of small nations should be done cautiously, and even within the natural geographical subgroups. With few exceptions, however, the acceleration of emerging-market growth around the world since the end of the Latin American debt crisis in the 1980s, has bypassed the Caribbean. Earlier, from 1972 to 1988, the Caribbean, as a group, strongly outperformed other emerging markets or small states in terms of GDP per capita or purchasing power parity (PPP). But since then, the region has strongly underperformed (International Monetary Fund [IMF], 2010). The picture of stalling relative growth is even worse if Trinidad and Tobago is removed from the equation. This is a reasonable adjustment given that Trinidad’s recent economic path has been driven by the favourable international prices of their primary export — gas and its derivatives.<sup>9</sup>

The woeful trend of the past 22 years continues in the Caribbean. While GDP growth in Latin America is forecast to average above six percent in 2011, it is expected to average just two percent in the region, and this is despite the fact that the Caribbean has further to bounce back, having suffered a greater decline during the recession of 2008–2009 than Latin America.

Public debt levels have risen to potentially unsustainable levels. Seven of the 10 most indebted countries in the world are in the Caribbean. Part of this debt relates to trying to satisfy expectations of the electorate for public services and expenditure not matched by tax

8 The British Navigation Act of 1651 effectively prohibited British trade in the Caribbean between possessions held by different colonial powers, by requiring all trade ships in ports they controlled to be made in England, to be sailing for England and to be captained by an English subject. The French followed this Act with their own *L’exclusif* laws. A cynic may observe that internationalism and protectionism are the X and Y chromosomes of Caribbean DNA.

9 Trinidad and Tobago is one of the world’s major exporters of ammonia, methanol and liquefied natural gas (LNG).

revenues. But public finances in the Caribbean have also been, and continue to be, disproportionately burdened by new expenditures relating to climate change, post-9/11 physical and financial security, and the growing trend towards reductions in customs tariffs.

The structural economic outlook is not obviously rosy. Agricultural and manufacturing exports are generally uncompetitive and have declined sharply since the late 1980s.<sup>10</sup> In some parts of the region, tourism is threatened by alarmingly high crime rates.<sup>11</sup> The international financial crisis, and the response to it, put the region’s international financial centres (IFCs) at risk.<sup>12</sup> Even before the assumption of liabilities following the Colonial Life Insurance Company (CLICO) and Stanford International Bank debacles,<sup>13</sup> debt levels placed tight constraints on governments of the region. Separately there has been a decline in the quality, efficiency and purposefulness of most governments.<sup>14</sup>

With the public sector overburdened by debt and inefficiencies, future growth must be private-sector led. This is easier said than done. The private sector, however, appears ill-equipped to set a rapid pace of economic activity or to take advantage of recently negotiated, concessionary, trade agreements such as the Economic Partnership Agreement (EPA) with the European Union

10 Caribbean exports, as a percentage of world exports, fell from 0.1 percent in 1990 to 0.05 percent in 2009.

11 According to the March 2007 report “Crime, Violence and Development: Trends, Costs and Policy Options in the Caribbean,” prepared jointly by the United Nations (UN) and the World Bank, murder rates in the Caribbean are higher than in any other region of the world, at around 30 per 100,000 population annually.

12 IFCs provide significant employment and tax revenues. In the case of Barbados, which is not considered to be one of the region’s major financial hubs, financial services comes after government and distributive trades as an employer, and contributes the largest share of corporate tax revenues as a sector at 60 percent.

13 CLICO was a large regional insurance company that became a methanol production developer in Trinidad and Tobago. Financed substantially by financial leveraging and diversified to a small extent in the Florida property market, the company collapsed when methanol prices and Florida property prices fell by more than 50 percent in 2008. Sir Alan Stanford ran an international bank out of Antigua, Stanford International, which became heavily involved in many aspects of the Antiguan economy. In February 2009, a US Securities and Exchange Commission investigation alleged Stanford International was a US\$9 billion Ponzi scheme, and the bank ceased to operate, causing a substantial shock to the Antiguan economy.

14 This was a common theme of the Barbados Entrepreneur Summit held at the Hilton in November 2010, recognized in the presentation to the summit by Prime Minister Stuart.

(EU).<sup>15</sup> The world is not waiting for the Caribbean. Many of the concessions granted in trade agreements that have yet to be implemented by Caribbean governments are necessarily temporary in order to comply with global trade rules; and all the time they are being eroded by new foreign trade agreements being implemented by Europe and the United States on the one hand, and Caribbean competitors on the other. Competitiveness is low in the region, with only one Caribbean country making the top 50 in the World Economic Forum's "Global Competitiveness Report" ranking for 2010–2011.<sup>16</sup> Talent is leaving the region.<sup>17</sup> Caribbean countries dominate the list of the top 20 countries in the world with the highest tertiary-educated migration rates.<sup>18</sup> Many in the Caribbean diaspora have found it easier to be successful abroad than at home,<sup>19</sup> further fuelling the "brain drain."

The response of governments in the region to slow economic growth, has, so far, been to fund expensive airports, subsidize airlines, provide fiscal incentives for agriculture and renewable energy, apply significant expenditures on education and provide tax incentives to boost third-party international business. These are typical "apple pie and ice cream" initiatives that few argue against. In those countries where the public sector

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15 The Caribbean region has one of the worst records for implementing trade agreements. Implementation includes, for example, legislative changes where independent veterinary authorities approve exports of certain livestock products, as opposed to the Ministry of Health, before they can be imported into the European Union.

16 Barbados ranks 43 out of 139, with Trinidad and Tobago, Jamaica and Guyana at 84, 95 and 110 respectively. According to the report, Barbados earned its relatively high ranking as a result of an efficient public sector, an observation that some in the private sector question.

17 This is not all bad news, as the departed talent sends money home. Remittances account for approximately 15 percent of gross national income for Jamaica and Guyana. Moreover, these cash flows tend to be counter-cyclical, rising when the recipient countries have been hit by natural or economic hurricanes. That said, remittances from those that have left is a useful prop, but is probably not a sustainable driver of development.

18 Emigration rates for tertiary-educated persons in the English-speaking Caribbean are among the highest in the world. Grenada, Guyana, Jamaica and St. Vincent and the Grenadines have tertiary emigration rates of 85 percent. St. Lucia, St. Kitts and Nevis, and Trinidad and Tobago have tertiary emigration rates of 70 percent, and the remaining English-speaking Caribbean had an average of 60 percent. Of the 25 nationals who graduated from the Cave Hill campus of the University of the West Indies in Barbados as junior doctors — some of the most expensive public education available — only five took up permanent positions in the country.

19 Such as Baroness Scotland, who became Attorney General for England and Wales in June 2007, and the parents of US Attorney General Eric H. Holder and Secretary of State Colin Powell.

is fiscally constrained, donors have often stepped in with similar agendas. However, we need to question if simply doing more of the same will actually lead to a different outcome.<sup>20</sup> While the areas being targeted by these initiatives may be right (education, tourism, environment, energy, agriculture, international business), the manner in which some of these investments are made, organized and linked to the rest of the economy need to be examined to ensure they are delivering lasting benefits.

Consider that most sacred of cows: public education. The Caribbean is justifiably proud of its investment in free, universal education amounting to around five percent of GDP per year. There have been very high social and economic returns from free primary and secondary education; however, after receiving a largely taxpayer-funded education, an estimated 50 percent of university graduates in the region as a whole, go abroad for work. This percentage is much higher in the English-speaking Caribbean.<sup>21</sup> Second, the education system is turning out a disproportionate number of doctors and lawyers who enter protected professions at home and are not a force for entrepreneurial change. Third, research ranking suggests that the incentives to the university and secondary schools may have tilted the balance too far towards quantity over quality. The concept of free education is not in question, as there are few things governments can do that can generate as much social and economic return. The question is, given the high cost, is existing public expenditure on education targeted and focused in the best possible way. Debate on the subject is largely stifled in the Caribbean, especially when compared with richer countries that, for instance, have already departed from free tertiary education.<sup>22</sup>

A similar story can be told for a range of apparently worthy initiatives under the skills agenda. There are a number of public sector officials with certificates and training courses under their belt, but improved skills matched to the same poor incentives will do little to lift productivity in the public sector. Moreover, many public officials may carry certificates of limited relevance to their day-to-day work. Certification is not education.

Even if this were not an age of austerity and deficit reduction, there are other popular public investments

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20 Albert Einstein is attributed with the aphorism that "insanity is doing the same thing over and over again and expecting different results."

21 See footnote 17.

22 One example is the United Kingdom.

that should be scrutinized. Large subsidies continue to be given to “sick” public transportation companies that sit alongside profitable private transport firms. Despite brand new airports and air-travel subsidies, several factors make it difficult to extract commercial returns on air transport investments, such as legacy labour costs, political demands to serve “social routes,”<sup>23</sup> high fuel costs and levies placed on air tickets.

In the past, the region’s charismatic, nationalist leaders cited the vulnerabilities of size and the legacy of the British Empire as reasons to insulate the regional economy from the “cold winds” of international competition. These issues do have legitimacy. Colonialism has left a legacy in the Caribbean; however, the recent experience of the region and elsewhere suggests that the answer to uncompetitive industries is not to provide continued protection from competition, but to expose these industries to competition. A strategy of gradualism may be more successful if it was combined with the aggressive removal of barriers within the region first. The essential point, however, is that trade policy is the most important policy consideration in pursuing increased competitiveness in the Caribbean, and lies at the fulcrum of the region’s problems and challenges.

In the past, Caribbean countries hoped to establish globally competitive industries through import-substituting industrialization (ISI).<sup>24</sup> Internationally competitive, but locally protected industries do not easily coexist. The success of import substitution has been debated, but no matter how economic history is interpreted, that path is no longer available given the realities of new trade rules that restrict special preferences and high

23 I first heard this term from Jean Holder, chairman of Liat Airlines, in reference to unprofitable, but socially important, routes. He discusses the issue further in his book: *Don’t Burn Our Bridges: The Case for Caribbean Carriers*.

24 ISI was a common policy strategy in a wide range of newly independent, developing countries from the 1950s to 1980s. It was associated with leading development thinkers, including Raúl Prebisch, Hans Singer, and Celso Furtado, among others. The policy strategy was essentially a combination of state-induced industrialization through governmental spending and protection of infant manufacturing industries. In the 1970s, Prime Ministers Barrow (Barbados), Burnham (Guyana), Manley (Jamaica) and Williams (Trinidad and Tobago) were devotees of ISI. Prime Minister Barrow argued that deficit spending was as much a development issue as a fiscal one. At the time, it seemed self-evident. ISI proponents argued that the South Korean and Japanese “economic miracles” of the 1960s and 1970s rested on import-substituting industrialization, while the problems of import-substitution that were to eventually materialize in the late 1970s and 1980s in the Caribbean and also in Argentina, Brazil, Britain, Mao’s China, Ecuador, Ghana, India, Indonesia, Italy, Mexico, Peru, Russia and its Eastern European satellites, Tanzania and elsewhere, had not yet done so when these ideas were at their zenith in the Caribbean.

public debt levels. Of course, these realities do not stop protectionism being touted in political hustings. As Adam Smith observed several hundred years ago, the voice and influence of existing, protected businesses, drowns out the disorganized voices of consumers and the putative voices of the yet-to-be-developed businesses. The political economy of protectionism is not unique to the Caribbean; however, protectionism is oddly more acute in small states where everyone personally knows the losers. The lack of fiscal space may be the Caribbean’s best driver for getting out of this particular political-economy rut.

### The “Luxury” of Limited Choice

Caribbean policy makers have the “luxury” of limited choices to guide their development path, when the following four economic realities are considered:

*Where overseas markets are large and local markets are small, there are few alternatives to an outward orientation, with export-driven growth and fading protectionism. Autarky does not work for small states (Briguglio, Persaud and Stern, 2000).*

*Where overseas markets are distant and countries are physically small and not well-endowed in energy and water, there is little alternative to the export of “weightless” products. The best examples are professional services, like medical diagnostic services, exported through a broadband connection.*

It is politically difficult to accept, but Caribbean countries are not able to compete with Australia or Brazil in sugar or other agricultural exports, with the clear exceptions of Guyana, Suriname and Belize that have much cultivatable land and relatively low wages. While some extreme members of the environmental lobby like the notion of “getting back to nature,” the Caribbean would be imprisoned in poverty if it only wove baskets for cruise ship passengers or exported sugar, bananas and coconuts. This does not mean that there is not the potential to better integrate agriculture and hotel sectors regionally, or there is not a role for high-value-added “bespoke” agricultural exports, where the value added lies in the marketing and packaging of specialty rums, sugars, chocolates, coffees, rare meats or fish (B. Persaud, 1988). However, it is unlikely that growth will be associated with a substantial increase in agricultural employment, especially in the smaller water- and energy-short states.

Similarly, Caribbean nations are not able to easily compete with Chinese and Indian manufacturers, except with subsidized energy and capital, which are not sustainable. Caribbean countries cannot produce mobile phones for a

few cents and cars for less than a thousand dollars. They can, however, provide a great place for professionals and artisans to live and work, attracting the location of what have been called “life-style location industries.” A large proportion of professional services such as legal, accounting, medical diagnostics, engineering, architectural, design, music production, editorial and financial services can be digitized and exported via broadband connection. A business environment that fosters international professional services, especially those found in financial centres, will also significantly raise the sophistication and linkages of Caribbean exports (Hidalgo et al., 2007). This should not, however, be about turning the Caribbean into cookie-cutter versions of the Cayman Islands and ignoring the world-renowned, creative vibrancy of Jamaica, Trinidad and Tobago and many of the other islands. Creative and artisan services such as luxury watch and fine jewellery repair, bespoke tailoring or intricate leather and metal craftsmanship are also relatively light per value, allowing for these services to be airfreighted around the world.

*Where capital is tightly held, coupled with a plantation legacy, there is little alternative but to encourage existing “establishment” businesses to expand regionally and globally, creating economic and political space for entrepreneurs, micro-enterprises and workers’ cooperatives. The legal arrangements to open overseas markets are already in place within CARICOM and the European Union. The Caribbean must move quickly to implement these agreements alongside efforts to widen the availability of finance.*

*Where countries are physically small and tourism is a large component of the economy, it is critical to invest in preserving and enriching the natural, constructed and social environment. There is no space to waste in a small state. Islands that are dependent on tourism disregard, at their peril, issues such as coastal management, water runoffs, waste management and social issues that keep tourists away — drugs, crime, corruption and general lawlessness.*

There are few viable alternative development paths to the ones cited above: outward orientation; weightless exports such as professional and financial services; supporting entrepreneurship through wider access to capital; and investing in a path that intertwines economic, social and environmental goals. This does not need to be an expensive agenda or imply that “big government” is required. What it absolutely must be is an activist agenda in certain critical areas that will be explored in this paper.

This paper is organized as follows. In the following section, the obstacles to change are examined. The Agents of Disruptive Change section describes what it means to have an aggressive technology and research policy, placing the consumer at the heart of decision making on delivery of public sector services, regulation of enterprises, trade and competition policy, and to support new ways of organizing capital. The Environment section briefly considers how the environment fits into the framework described in the previous section. The next section concentrates on the particular role of the international financial services sector, which represents a major component of revenue and employment for several Caribbean countries. In the Regionalism section, the role regionalism plays in this agenda is assessed. The Conclusion provides a summary of the discussion points in the paper.

## Obstacles to Change

The catalyst for change in the Caribbean will not emerge from another discussion of what Caribbean countries should do. The desks of Caribbean permanent secretaries are stacked with yellowing consultancy reports. The real question is not the *what*, but the *why*? Why, in spite of knowing everything we do, has change not materialized? There are physical and financial constraints and implementation deficiencies, but the overriding constraints are matters of political economy.

The economic framework shapes the political structure, making it hard for governments to reshape the economic structure. State employment is high and few political parties will risk the wrath of public sector workers. Enterprises that benefit the most from special preferences are major benefactors to social initiatives. New and radical initiatives to transform the country can find no other sponsors than the old, established businesses resistant to disruptive change.<sup>25</sup> An inefficient public sector benefits the “insiders” — those middle and upper classes with

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25 It would be wrong to tar all business people with this brush. In all Caribbean countries, there are many innovative and entrepreneurial business people that have not only benefited from opportunities, but feel agile enough to survive in an environment of flux. Larger economies such as Trinidad and Tobago and Jamaica have a number of such entrepreneurs, but they also exist in the smaller states — for example, residing within the 14 by 22 miles of Barbados are Ralph (Bizzy) Williams, who won the 2001 Ernst & Young World Entrepreneur of the Year Award, the Goddard family, who own the multinational Goddard’s Flight Kitchen and others, and also Yesu Persaud (not related to the author) of “Eldorado Rum” fame from Guyana.

connections<sup>26</sup> — versus the “outsiders” (Feldmann, 2008). These powerful forces against change are not unique to the Caribbean, but they are more entrenched in small or developing states where the middle and upper classes have a distinctly different existence than the poor — the rich and poor in Kingston, Jamaica, live in two very different and distinct Kingstons.<sup>27</sup> The political economy constraint to the governance and modernization of small states is, perhaps, the single most important argument for greater regionalism.

If the *what* ignores the political economy context, initiatives are likely to become subsumed by the forces of stagnation. Today’s new institutions and new investments are destined to become tomorrow’s new obstacles. The creation of “tourism development investment funds,” originally designed as an agent of modernization, now combine with other incentives to become the subsidy that enables unprofitable and inefficient businesses to cling to occupation of scarce beach lands, which impedes the development of the industry. With a few exceptions that prove the rule, the University of the West Indies (UWI), a beneficiary of substantial government grants, is no longer a source of rich domestic policy analysis,<sup>28</sup> radical reform or internationally renowned research expertise.<sup>29</sup> In some areas, the university can be a reactionary agent to greater export orientation (Girvan, 2008).

In contemplating enduring, sustainable change, those changes that have the potential for disruption, not in a willful sense, but as a source of innovation, need to be the priority. Too many of the existing instruments and strategies — grand construction projects, new university

26 The vocal middle classes don’t complain as much as they might in a larger country about the wait times for renewing passports, licenses or identification cards, or the need for police certifications of good character or notaries to sign every document, because they know someone who will do it for them more quickly. These people are the “insiders,” able to get planning permission to build over the sea or open a new restaurant, while others with legitimate entrepreneurial ideas are frustrated in their efforts by slow, ad hoc processes.

27 Dr. John Rapley and colleagues have developed an interesting thesis that argues that the Caribbean has seen the emergence of an “anti-growth coalition” of business, unions and professional middle classes. See Renee Bowen, Cecilia Mo and John Rapley, “Anti-growth regimes: micro foundations of inefficient democracies” (forthcoming).

28 During the debate on the EPA, university academics were the vanguard of support for preserving an economic order of protectionism and import substitution that is not available under international trade agreements.

29 Average citations in peer review journals per academic are now closer to 50 than the 1,000 plus that would be expected in a mid-level university in the United States.

centres and buildings, and renewable energy projects with strategic business partners — necessarily favour and reinforce the established order and keep the channels of influence and payments well lubricated. This means thinking as much about incentives as institutions. It means focusing on enabling outcomes rather than betting on single, big, prescriptive solutions. In the English-speaking Caribbean, hosting the 2007 Cricket World Cup, with the associated large investments in stadia and port infrastructure, was meant to be a catalyst for development, but most of these aspirations appear unfulfilled.

The critical instruments of disruptive change are technology, finance, business facilitation and competition. Critical strategies for governments include an aggressive stance towards:

- Exploiting technology;
- Reorganizing the delivery of public services to place the citizen/consumer at the centre of allocation decisions;
- Nudging the establishment of new organizations of capital — without providing much capital; and
- Taking a more aggressive stance to regional trade and national competition policy.

These ideas are often glibly expressed, but seldom translated into practical policy strategy; therefore, the next section describes what these strategies mean and how to implement them.

## Agents of Disruptive Change

### An Aggressive Technology and Research Policy

Large developed countries can afford to allow the market to set the pace of technological change within their countries. Small states do not have this luxury. Without the benefit of economies of scale to land, employment and capital, technology is often a critical ingredient for small countries to remain competitive.

Where local markets are small and overseas markets are distant, broadband connectivity is as essential to economic development as roads, airports and electricity. In today’s world, it is a primary factor of development. While the returns on investment in airports in the region may be diminishing, increasing access to broadband will create greater potential for investment opportunities. Across all sectors, industry incumbents will resist restructuring

their industries, and in small economies, the influence of existing industry owners through employment and cash flows is considerable. If Caribbean countries are to be successful in the modern age, government needs to take a proactive stance in the development and promotion of broader, cheaper access to information communication technology (ICT).

### ICT Infrastructure

A prerequisite for exporting professional services to large, distant markets is cheap, high bandwidth. Technology can overcome the physical obstacles of distance and geography. Countries lying on the outskirts of poorly connected areas, in hard-to-reach regions, can, through broadband, be in the fast lane of the communications superhighway. Broadband enables and promotes weightless exports, but it must be both dependable and high capacity. The ability to download the architectural drawings of a hotel, a series of detailed medical scans or tradable financial data, or support high-definition video conference calls, all require high bandwidth — dial-up simply won't work.

Simply being on the communication superhighway can introduce competition into local markets by plugging local consumers into global markets. The local customs office could offer a “plug-in” to online retailers allowing goods to be taxed online and appropriately labelled, so they can be delivered directly to purchasers and eliminate the need for these goods to be processed by an already-congested customs authority.<sup>30</sup> Land-locked Hungary is an example of a country that, through investments in ICT, has positioned itself at the virtual heart of the European Union.

### E-government

Technology can potentially cut the distance between citizens and government. It can dramatically improve how government serves its citizens in a myriad of ways, but most obviously through the licensing and regulatory process. There is no reason why the renewal of licenses and other approvals, where original documentation has already been received, validated and electronically filed, cannot be processed online at a government website. While the marginal costs of increasing coverage of such

30 Customers would benefit from such an initiative, but non-convenience stores (department stores selling non-perishables, for example) would lose. The distributive trades sector, however, is a major employer and this would have to be considered and potentially mitigated through online surcharges transferred back to the centre via lower value-added tax (VAT), for instance.

services are low, users would no doubt be prepared to pay surcharges for the convenience and cost savings of no longer having to spend time in long queues in poorly ventilated government offices.<sup>31</sup> Such surcharges could be used to fund both the initial expenditure on e-government, as well as the gradual restructuring of public sector employment away from such activities through retraining for alternative employment or to pay for attractive redundancy arrangements. Technology can also be used to improve customs logistics and clearing — a key constraint to trade in the wider Caribbean.<sup>32</sup>

The economics of ICT — high fixed costs and low variable costs — lends itself to a “natural” monopoly. In small states in general and the Caribbean in particular, ICT is often left to a sleepy private sector monopoly for residential fixed lines and duopolies for mobile and business telephony. Not surprisingly, this model has failed to deliver cheap broadband or promote innovation compared to the services available in larger or developed markets. Some maintain that Caribbean markets are too small to sustain a competitive market. It is interesting to note that following the liberalization of telecoms regulation, Denmark, one of the smallest European countries in a region of mega-telecoms players, now has some 62 different telecom providers, proving that geographical size is perhaps less of a constraint on competition than has been thought. Given the importance of ICT infrastructure, there is also scope for some “pump priming” investments ahead of market development.

### Technology Policy

Apart from the political economy challenges discussed above, there are a number of technical ways in which ICT infrastructure can be promoted. Much turns on the commercial viability of a particular market, and governments will have to do some experimenting before they find the optimal solution for their individual circumstances. Where existing arrangements with incumbents impede change, governments could

31 Anecdotal evidence suggests that employers expect workers to spend six days a year absent from work in a queue for some utility. Six days out of 250 working days represents 2.5 percent of working time and could be reasonably expected to be approximately equivalent to 2.5 percent of lost GDP.

32 In a survey of 150 countries, the Caribbean ranked poorly on trade facilitation. Three countries, Guyana, Haiti and Jamaica, were ranked 141, 123 and 118 respectively. The reasons cited for the low rankings are the lack of efficient customs practices, timeliness of the clearing process, over regulation and poor logistics competence. See World Bank, *Connecting to Compete: Trade Logistics in the Global Economy* (2010).

focus instead on new technologies and generations of connectivity, such as 3G, 4G and WiMAX.

One idea would be for governments to insist that a company offer some degree of free 3G connectivity to the public, as a precedent condition to being awarded any new 3G or 4G licence. The amount of “useful” connectivity will, however, change over time.<sup>33</sup> It is critical that governments avoid arrangements with predetermined technology platforms and firms. What is required is regulation, not controlling ownership. Alternatively, through an annual auction a government could buy a certain amount of free broadband access for any citizen or any company registered in the country, funded either through the proceeds of the sale of licences or by taxes and charges on service providers. Such an initiative would lead to enormous, positive, disruptive power at a small and falling cost.

Governments could, effectively, sponsor entire islands (Barbados, Antigua, Aruba) or cities (Kingston, Port-of-Spain, Georgetown) becoming wireless (or WiMAX) zones, free below a certain level of bandwidth<sup>34</sup> that would be sufficient for a start-up business or for the marketing of local businesses. The business brands of Caribbean islands would change dramatically if business people visiting for either vacation or work discovered they have free, island-wide broadband service.

Of course, a key constraint for many Caribbean states is their small size and distance from other markets. In this regard, there is significant scope for a regional approach to the provision of hardware connectivity. There have already been advances in this area, most notably the Eastern Caribbean Fibre Optic System owned by France Telecom, Cable & Wireless and AT&T, which was launched in 1995 connecting all of the eastern Caribbean.

### Research Centres

Research into technological innovations should also be fostered. The region used to boast a long and proud history in the area of regional agricultural research. In the English-speaking Caribbean, regional research programs in soils, bananas and cocoa began in 1946-47 at the Imperial College of Tropical Agriculture (ICTA), and by 1960 when the ICTA was merged with the University College of the West Indies to become the Regional Research Centre

33 The amount of computer RAM required to run word processing programs has grown in line with the increased availability of RAM.

34 A suggestion would be 0.5 megabytes.

(RRC), there were world-renowned research programs in tropical plant breeding and herbicides. The heyday of the RRC was during the 1960s, when the pioneering research work done on pigeon peas and root crops, and on pest, disease and weed management was highly respected internationally.

In the 1970s, other countries and regions stepped up their national efforts in agricultural research,<sup>35</sup> which made funding in the Caribbean scarce. The regional emphasis switched from applying research to real-world problems facing farmers to other things, including supplementing agricultural research in agricultural ministries. Regional research efforts diminished as a driver of innovation around the same time as a decline was witnessed in the region’s competitiveness in agricultural products, such as sugar, rice, cocoa and tropical fruits. Strengthening research and development (R&D) capacity at research institutes with strong connections to the agricultural sector will be a critical component in maintaining and deepening competitiveness in these products. (It is important to note that R&D is a network activity and is also strongly dependent on investment in ICT capacity.) Over time, there were increasingly loud complaints that research was not sufficiently “applied” or “practitioner-oriented.” This is not an uncommon complaint of university-led initiatives and is also cited with regards to R&D in the Caribbean financial sector. This subject is discussed in greater detail later in the section International Financial Services Sector.

## Consumer-driven Decisions on Public Sector Services, Corporate Regulation and Trade and Competition Policy

### Public Transport

The public sector, on average, represents approximately 30 percent of employment and GDP in the Caribbean. Governments in the region, as elsewhere, use expenditure to maximize the power of patronage, but this also constrains consumer choice and production innovation, clearly demonstrated in the public transport sector.

An inexpensive, dependable transport system has substantial positive economic, social and environmental externalities. Yet, sitting alongside the heavily subsidized

35 India’s Green Revolution from 1965 to 1980, was led by the introduction of high-yielding varieties of seeds (plus improved irrigation and fertilizers) following research collaboration between India and Mexico. Since the 1960s, grain production in India has increased sevenfold and the incidence of famine has fallen dramatically. Dr. Norman Borlaug, who pioneered the research, won a Nobel Prize in 1970.

state bus companies (often with expensive, broken-down buses parked in bus depots in the centre of town, employing well-paid drivers to operate buses that are often empty) are profitable, private operators.<sup>36</sup> This reveals a need for greater competitiveness in this industry. Governments could replace transport corporations with transport authorities, which would enforce service quality and quantity, health and safety regulations, and oversee auctions on routes. Auctions could be held where an operator could bid on the basis of the quality, frequency and fares they would offer, on the basis of a lump-sum subsidy for unpopular routes, or perhaps a fee to the government for ownership of popular routes. Mechanisms would need to be put into place for operators to develop new routes.

Developed countries<sup>37</sup> have several ready-made templates that the region might consider. These existing templates could increase consumer surpluses and improve service quality, as well as diversity. These templates, however, are also likely to reinforce the existing concentration of capital and face substantial opposition from public sector unions legitimately concerned that consumer surpluses will be achieved at the expense of workers' benefits and rights. If, however, governments were to also provide long-term leasing arrangements for the purchase of buses for small driver-owned cooperatives, it would serve to expand capital and business ownership, spread the example of entrepreneurship and facilitate the adjustment from public to private employment.<sup>38</sup> This model can also be replicated for reform of other public sector activities, including sanitation, highway maintenance and cleaning, providing a powerful opportunity for entrepreneurial empowerment through cooperative outsourcing.

### Increasing Private Delivery of Publicly Funded Education and Health

Caribbean governments spend substantial proportions of GDP on education and an increasing proportion on

health.<sup>39</sup> In these two areas, strong private benefits exist, but the social externalities are large, although not uniform across all levels of education or health. There is scope for more precise targeting of public funds to improve outcomes. Today in the Caribbean, education and health services are supply driven by a state monopoly. In the case of education, the state provides the buildings, teachers and curriculum. Being supply driven rather than demand driven has slowed innovation. Where pressure for change does exist, it often serves the suppliers, such as government departments and public sector workers, rather than the users. There is the opportunity for Caribbean governments to experiment, perhaps first in enterprise zones, with private delivery of certain publicly funded education and health services to support innovation, diversity and quality.

Removing the monopoly in education, while maintaining public funding for universal access, would allow for the creation of a consumer-driven, competitive sector that could become an "exporter," earning foreign exchange revenues with the potential to grow beyond captured domestic markets (Cable and Persaud, 1987). Education and health tourism are big business globally (Voigt et al., 2010). There is already a modest stream of parents in the diaspora sending their children back to the Caribbean to be educated, because they are concerned about the lack of discipline and discrimination at the schools in metropolitan centres. There is regional investment in education tourism, most notably in Grenada, Antigua and St. Kitts. However, these operations deliberately function in separate regulatory regimes, thereby cutting off the potential benefits to local suppliers and consumers. Simply pulling down these regulatory walls would be a start.

As previously mentioned, the English-speaking Caribbean has the highest rates of tertiary emigration in the world, with 70 percent of UWI graduates going abroad to seek work. This loss of talent in the region is compounded by the fact that this education is funded largely by relatively poor taxpayers, when compared to taxpayers in the countries gaining the graduates. Tertiary emigration is not necessarily bad. Small states, with limited absorptive capacity, have to be in the business of exporting and importing talent. The problem lies in how this tertiary emigration is funded and how, over time, these people are encouraged to return or be engaged in the region.

36 More commonly known as "Maxi-taxis" in Trinidad and Tobago, and "ZRs" in Barbados.

37 For example, in Germany, Sweden and the United Kingdom.

38 While there are few examples of this particular arrangement, there are examples of the public sector helping private sector operators purchase buses by committing to long-term bus leases that private sector firms operate. An example of such a public-private partnership arrangement is in the Indian state of Maharashtra, where Pune Maharashtra Parivahan Mahamandal Limited — a state-owned special purpose vehicle — leases, regulates and provides administrative support to private companies that operate and maintain the buses.

39 An average of 5 percent and 3.2 percent respectively, although the average hides a range in which some countries are spending significantly more than might be expected. In Barbados, the government spends approximately US\$1,000 per capita on public education.

There are several ways to deal with the issue of funding export talent. After a certain age, students could be granted a government-funded education account, whereby a student could spend funds from the account on any approved education service.<sup>40</sup> This amounts to a system of public funds providing private choice. The account could convert into a fixed-term loan if the user emigrates and leaves the local tax system.<sup>41</sup> If loan repayments of educated emigrants were used to increase the size of education accounts (and expenditure) for those being educated back home, and emigration levels remained unchanged (because they reflected structural issues of economic size and opportunities), governments could double initial education expenditures to a rank-busting 10 percent of GDP without being required to increase actual government expenditure.

Further, a mechanism where the used proportion of individual education accounts converts into long-term, repayable loans with enforcement powers if citizens emigrate and become tax payers elsewhere, would have common elements across a number of countries. It would be wasteful, with the diseconomies of small scale for each country to develop a similar collection mechanism that could be based around the regional university UWI.

Another problem arises in many parts of the Caribbean, where those who have worked and paid taxes abroad return to the region to retire close to their family and friends. In some countries, this represents a new and increasing burden on health services. To help mitigate these costs, government-funded health accounts could be set up for local taxpayers to cover medication and treatment for non-emergency, public health services. To encourage wise health choices, these account holders could transfer part of an unused account for use in future years or to friends and family in need. Unlike education, substantial private health markets already exist in the Caribbean as a result of the absence of state-funded health care,<sup>42</sup> and this would be a way of broadening access to this market, giving it the funding stability that could allow investments in service provision, quality of care, marketing and exports.

40 There are a number of education voucher schemes around the world, including schemes with varying degrees of success and controversy in the United States, UK, Sweden, Chile, Ireland and Hong Kong.

41 Governments could encourage repayment by automatically informing international credit scoring agencies if loan repayments are not kept up to date.

42 Trinidad and Tobago boasts 10 small private hospitals and 29 medical clinics.

Critically, it would reduce pressure on the emergency services at public hospitals and provide resources for non-emergency care to those who cannot afford it. This could trigger increased investments in medical services, making the islands even more attractive to those considering retirement back home (Bernal, 2007).

### Corporate Regulation: Taxes and Subsidies

There is much that can be done to simplify tax codes in Caribbean countries, which would narrow and focus incentives, making collection easier. There are a number of successful international examples<sup>43</sup> of simplified tax regimes, and a few programs already exist to accomplish this in the region through the Caribbean Regional Technical Assistance Centre. Simplification of the tax code helps to make incentives clearer, reducing the number of instances of tax incentives neutralizing themselves while leaving the treasury bereft of revenues.<sup>44</sup>

In the developed world, tax policy is used as an active tool of social, economic policy and environment policy. In developing countries in general and the Caribbean in particular, the use of tax as an environment or social policy is marginalized by the single-minded focus on revenues. Punitive taxes on new cars in, for example, Trinidad and Tobago and Barbados, are not in place to reduce congestion, but to raise revenues; therefore, governments sometimes turn a blind eye to the negative spillovers of higher revenue initiatives.

The need to better align the tax and subsidy system with pressing environmental concerns, such as the use of polluting fuels, congestion, waste management, coastal erosion and soil maintenance, is discussed in the next section. In the Caribbean, where land is generally in short supply and the environment fragile but crucial to tourism industries, increasing the tax rate on property and environmental taxes and lowering income taxes and import duties could incentivize efficient land use. This system also has the advantages of being easier to collect

43 In 2004, Egypt embarked upon a tax reform that included many of what are considered “best practices” of a simplified tax system. In response, the number of tax returns filed jumped by 50 percent in the first year and, despite cutting tax rates by 50 percent, tax revenues increased from seven percent to nine percent of GDP.

44 Barbados gives a water subsidy for farmers to support agriculture; however, because farmers receive this subsidy, they do not bother to collect rainwater and there is another subsidy to encourage them to do so. Scrapping both of these subsidies might boost net revenues and improve water conservation, which would allow the government to lower tax rates overall.

and harder to evade and would include foreigners who are living in the jurisdiction temporarily or foreigners who own second homes there. It would allow the region to become a low-income and corporate tax regime. Of course, shifting the tax burden to the landed rich would not be easy politically.

Governments should, as argued elsewhere in this paper, be size sensitive when creating regulatory regimes, ensuring that the reporting and tax burdens are size and risk sensitive and have the least effect on those enterprises that have the smallest impact on neighbours or the wider physical and social environment. This applies, critically, to tax rates and tax reporting, and not just for corporate taxes, but also VAT and other excise duties, fees and charges. There are income and employment thresholds already in place in some jurisdictions where there is no corporate tax or VAT payable, and only modest reporting requirements in order to support emerging businesses.<sup>45</sup> But these thresholds need to be raised further (to limit the potential for small and young firms to quickly fall afoul of the VAT rules, discouraging them from growing) and this can be done without depriving the treasuries of significant tax revenues — discussed in greater detail below (Winters and Martins, 2005).

### Size Intolerance: Decriminalizing Entrepreneurship

It is sometimes argued that where governments are corrupt, taxpayers consider the raising of taxes as illegitimate and tax evasion as acceptable. Tax evasion is not about ingrained lawlessness. In these circumstances, increasing the legitimacy of government is critical to reducing tax evasion. In a similar vein, the plantation legacy in the Caribbean has produced a workforce with a strong belief that the economic structure is illegitimate, with no appetite for working in large companies and with a culture of distinct discomfort in providing service. This lack of enthusiasm for work is often incorrectly mistaken for a general unwillingness to work, a poor work ethic and various politically incorrect euphemisms for laziness. It is not.

There is a significant segment of the population who are sole traders in micro-businesses. The problem is

<sup>45</sup> In Barbados, the earnings threshold for paying VAT is a turnover of more than BDS\$60,000, equivalent to US\$30,000. Assuming a profit margin of five percent, an entrepreneur earning more than US\$2,500 would have to be VAT registered and pay VAT. This limit could be increased tenfold without hurting government revenues, when existing non-compliance is taken into account, while boosting the incentives to entrepreneurship.

that they are often not legal businesses.<sup>46</sup> The popular food stall opposite the Hyatt Regency in Port-of-Spain, Trinidad, illegally occupies its spot. The beauty salon in a converted room in the home off Rendezvous, in Bridgetown, Barbados, does not have planning permission and is not VAT registered. This is largely the result of the high cost of doing business in the Caribbean, where almost every transaction requires an expensive, busy lawyer to stamp it, or a lengthy, seemingly ad hoc, approval process,<sup>47</sup> or where VAT or corporate tax thresholds are low. But without legality, there is no scope for these informal businesses to borrow to invest and expand, or receive state support, tax credits or the like. The semi-legal status of these firms inhibits their expansion and allows their proprietors' frustrations to fester. A vast amount of entrepreneurial economic activity in the Caribbean dies a premature death in this twilight zone.

Government regulatory regimes are size intolerant. Local big businesses like it this way. They argue that the same health and safety standards must apply whether a restaurant has one table or 100 and, in this particular example, this is true. But there is room to create regulatory fast-track regimes for businesses with limited impact on others, or thresholds that would allow micro-businesses to be exempt from regulations and registrations when the risks the state is trying to manage are size sensitive; this would allow start-ups to have some breathing space instead of being stillborn. The one-on-one yoga class in Chaguanas, Trinidad, should not be required to submit to the same approval process as a gym with two dozen treadmills.

When small businesses operate outside the legal corporate structure, they often have very few assets available for security; therefore, the risk premia they pay to borrow money or raise equity is punitive. Ownership of land and other assets is often not registered, and to do so is an expensive, slow process.<sup>48</sup> A program of secured lending could be introduced, where assets are registered

<sup>46</sup> The informal sector is estimated to be in the region of 45 percent to 51 percent in St. Vincent and the Grenadines, Belize and the Dominican Republic in Guillermo Vuletin's IMF Working Paper, "Measuring the Informal Economy in Latin America and the Caribbean" (2008).

<sup>47</sup> According to the World Bank's *Doing Business Report 2009*, only three Caribbean countries made the top-50 ranking of nations for overall ease of doing business. The highest-ranking Caribbean country was St. Lucia at number 34.

<sup>48</sup> Charisse Griffith-Charles (2007) reports that as much as 40 percent of land parcels have inadequate documentation to support the occupants' rights.

so they may serve as collateral.<sup>49</sup> This “property rights” agenda is far from new,<sup>50</sup> but it remains highly relevant and important in the Caribbean. An added dimension to the issue of property rights in the Caribbean is that a protected legal profession obtains high, short-term “rents/fees” due to the hazy or absent property rights,<sup>51</sup> and this is the profession of choice for bright, middle-class locals who, without access to capital, have few other alternatives, creating a powerful incentive for a coalition between the political and lawyer classes — often one and the same — to preserve the status quo.<sup>52</sup>

The requirement for legal or similar representations and accounting rules must be narrowed and facilitated. If a lawyer is not required to set up and run a business in the United States or the United Kingdom, why should an expensive lawyer be necessary to set up a nano firm in a small state? It should be possible to set up online registrations and applications.<sup>53</sup>

49 The government in Slovakia, named the top reformer in doing business by the World Bank, introduced a Secured Transaction Legal Framework, which included provision for both moveable and immovable assets to be used as collateral, a reduction of formalities, including abolition of the requirement for notarized documents, establishment of creditor priority immediately upon registration with information available instantly, abolition of super-priority of tax liens so that tax authorities have to register their claims alongside other secured creditors and more efficient enforcement through the law on auctions that make the timely sale of collateral possible. Following these reforms, registrations increased from 7,508 in 2003 to 31,968 in 2007, and the time needed to foreclose on a mortgage decreased from 560 days to 45 days. In Romania, similar results followed from similar reforms, with registrations jumping from 65,227 in 2000 to 536,067 in 2006 and, most interestingly, the development by banks of new lending products associated with falling borrowing costs.

50 See Frédéric Bastiat, *Economic Harmonies* ([1850], 2006), Hernando De Soto, *The Other Path: The Invisible Revolution in the Third World* (1989) and Hernando De Soto and Francis Cheneval, *Realizing Property Rights* (2006).

51 In many Caribbean countries, lawyers receive officially mandated “scale fees” for activities that are remunerated by a fraction of the fee in countries with well-developed property rights and registration, and a less protected profession.

52 Similar to business people mentioned earlier in this paper, it would be wrong to tarnish all lawyers with this brush, and many distinguished regional lawyers are at the forefront of reform, such as the Honourable Mia Mottley Q.C.

53 In April 2006, the Justice Ministry in Estonia prioritized the creation of a business registration process that could be completed in two hours. In addition to the time savings (manual registrations took one week), the reforms led to a 130 percent increase in the annual number of enterprises registered from 1998 to 2008. In 2001, the Companies Commission of Malaysia introduced e-lodgement, which cut registration time from 30 days to one day for sole proprietors. Compliance rates for filing annual returns jumped from 44 percent to 91 percent, and the number of new companies registered annually increased by 58 percent.

The theme of high legal costs acting as a barrier to business is evident once again. Ending professional monopolies in the legal profession will considerably reduce the cost of doing business in the Caribbean. A first step to breaking this monopoly is to expand the network of mutual recognition of lawyers from other jurisdictions for non-court practice. In the United Kingdom — a relatively large and competitive economy, where the gains to competitive reforms might be expected to be far more marginal — the end of the legal profession’s monopolies in 1985 on an range of activities, including conveyance, reduced the cost of transactions considerably, and established a new, highly technical and efficient conveyancing industry.

In general, the Caribbean exhibits high barriers to business entry, coupled with poor monitoring and ad hoc consequences for non-compliance. The exact opposite is needed: appropriate regulations with an easy application process and simple validation, fortified by strict monitoring and tough consequences for false or incorrect applications. The gates need to be lowered, but we need to have strong floodlights to see what is going on inside. Instead, we erect high walls, and for those who manage to clamber over the top, much goes on in the shadows. This is not a random occurrence, but one that should be expected where governments are weak and well-off professions are strong. Often, in the name of regulation to protect the vulnerable, middle-class professionals make off like bandits. In dealing with business, government must become more size-tolerant if it is to promote entrepreneurship. Given the concentration of capital and the view that legacy businesses are illegitimate, converting this entrepreneurial energy into legal business activity is crucial for the private sector to develop, employment to grow, and, most importantly, for business to be seen as a legitimate career.

## Interventions to Support New Organizations of Capital

Banks are not a ready source of risk capital in the Caribbean or in other jurisdictions. In many countries in the region, governments have tried to make the public sector a source of risk capital, but this is fraught with difficulty. Public-sector risk capital in the Caribbean is often administered by the national central bank,<sup>54</sup> the main depository of financial expertise. But central banks are also, quite correctly, centres of risk aversion and strict processes; therefore, these facilities, which require bold

54 Such as the Enterprise Growth Fund in Barbados and the Eastern Caribbean Enterprise Fund.

and risky judgment, are often poorly utilized. Moreover, government involvement in the allocation of risk capital makes the central bank vulnerable to the pressures of special pleading, vested interests and the commercial fashions of the day. There is much that can be done to deepen the financial sector and lower the cost of financial intermediation that is just shy of government-directed “lending,” and its litany of associated potential problems.

Governments should support the establishment of factoring agencies, where invoices can be used as security for loans. This process could be kick-started by governments offering to guarantee loans that are backed by a government contract and invoice.<sup>55</sup> The cost of this measure would be minimal, but its catalytic effect significant — especially where the government in question has a procurement strategy supporting small businesses. In effect, the government would be taking on the risk that it will renege on its own contractual arrangements — a risk the government should be far more willing to take on than anyone else.

Micro-leases and micro-insurance are other critical factors required for micro-businesses to flourish. Governments could offer co-insurance of the risks of micro-leases and micro-insurance, where there are tangible assets. In essence, the government would be taking on a risk that is directly correlated with the success of its own law enforcement.<sup>56</sup> We have already discussed the idea of governments offering leases to worker cooperatives or ownership teams to purchase vehicles to deliver public services. Where these are long-term public services, such as sanitation, public transport, licensing authorities and airports, it seems appropriate for national insurance boards to become involved in backing some of these new businesses.

Another constraint to expanding the financial sector is the pursuit of narrow, national interests. There are limited cross-border mergers and acquisitions, or even regional recognition of financial institutions. As a starting point, a regional protocol for the regulation of cross-border mergers and acquisitions needs to be established. An

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55 In the United Kingdom, the SME Invoice Finance scheme of the Enterprise Finance Guarantee will guarantee up to 75 percent of a loan backed by invoices.

56 This is especially the case in small, remote locations where effective law enforcement can be more successful. See David King, “Nowhere to Run: Theft of Motorcycles in a Remote Island Location” (2001).

example of a regional protocol would be one where regional regulators agreed that the jurisdiction of the firm being acquired or of the smaller firm being merged, where shareholders are most vulnerable to abuse, would be the lead regulator of the transaction and all activities relating to the transaction. One of the key obstacles to the bid by Trinidad and Tobago’s ANSA McAL for Barbados Shipping & Trading (BS&T) based in Barbados, was the presence of two regulators applying different, and at times conflicting, regulations.

A regional stock market may also support the growth of a Caribbean-wide financial and capital market. This is an idea that has often been discussed, and a better approach may be for the region to first try something less ambitious, such as deepening the network of cross-listings and/or removing or reducing restrictions that public and private pension funds have in investing in stocks on foreign, but regional, exchanges. Stock markets would then compete to see which one could become the place of primary listing, based on the results of who had the superior listing network, technology, cost structure and credible regulation.

## Trade and Competition Policy

As stated earlier, trade policy is the most important policy consideration in the pursuit of increased competitiveness in the Caribbean and lies at the fulcrum of the region’s problems and challenges. This section serves to highlight some of the broader policy issues. A cursory glance would suggest that the Caribbean’s trade arrangements are clear and supportive. At the international level, there are reciprocal agreements for deepening and widening market access that have asymmetrical timing arrangements, affording Caribbean producers a longer period of adjustment to imports, but immediate access to large markets — the recently negotiated EPA being a case in point, as well as the currently being negotiated free trade agreement with Canada. At the regional level, measures are being implemented toward a single Caribbean market in terms of free movement of capital and, most recently, of labour. CARICOM member states have also made a commitment to the establishment of national competition authorities.

The Caribbean, however, has a long tradition of not implementing international trade agreements. The private sector appears unprepared at best and, at worst, disinterested in the hard-fought concessions, apparently unaware that they are only temporary. The Caribbean Single Market and Economy (CSME) appears to be

crumbling beneath the weight of political indifference. Despite all the noisy chatter about the high cost of living and price gouging by monopolistic retailers, competition authorities have yet to be established, with the notable exception of Barbados.

One way forward is for the CSME to be aggressively pursued. If free movement of labour is too much of a political hot potato in the current recessionary environment, it is not a sufficient reason to abandon the goal of free movement of capital and better regional dispersion of innovation and technology. Now is the time to pursue a regional mergers and acquisitions protocol and common arrangements that would facilitate the emergence of a regional stock market. Traditional trade theorists would argue that free movement of labour becomes less important where there is proper free movement of goods, capital and technology.

Governments need to implement the EPA and regional companies need to exploit it. Efforts to do so would be helped by increased marketing of the EPA's opportunities in the local and international press to engage the Caribbean and its diaspora in the process. One important step in this direction is Caribbean Export.<sup>57</sup> More financial support is needed to strengthen the regional trade negotiating machinery and office. More investment in trade facilitation, such as overseas marketing campaigns, is required. There may be little that is new in the trade facilitation agenda, but it remains an important area where the wider returns from investment remain high.

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57 Caribbean Export will manage a large part of the funding for EPA implementation through a regional private sector development program that will have total funding of US\$37 million. The intention is that this will support the creation of a regional investment and export strategy and its implementation; a regional trade and market intelligence system; increasing private sector awareness of bilateral, regional and international trade agreements; and help with identifying export opportunities in the French, British and Dutch territories in the region. Caribbean Export is also intended to: identify and support niche sectors that benefit from the provisions of the EPA; provide financial support to export ready firms; and help develop the capacity of business support organizations to allow them to provide a wider range and quality of services. Practically, this should mean support for those industries that can use the EPA such as tourism, the emerging regional and national services alliances, value-added agriculture or, for example, the movie industry. See David Jessop, "Time is short for breathing life into the EPA" (2010).

## The Environment and Natural Resources

### A Balance Sheet Approach to Economic Policy

States with economies based around natural resources, such as Trinidad and Tobago, but also the tourism-based economies of the Caribbean, need to adopt a stricter balance sheet approach to economic progress, rather than relying on traditional GDP or income and expenditure markers. Income derived from depleting a natural resource and subsequently spent on temporary consumption, shows up as development and growth in traditional income-expenditure measures of GDP. Countries that are growing at two to three percent per year on the basis of exploiting resources in a non-renewable manner — this can include beaches and reefs as well as gas reserves — are, in reality, probably shrinking. In a balance sheet model, this kind of economic growth would be revealed as a deterioration of capital stock.

To move medium-term economic strategies and policies towards spending income derived from permanent capital, and reinvesting income derived from depleting natural resources to preserve, expand and liquefy the capital stock, states need to record and measure their assets and liabilities as a company would in its balance sheet. This national balance sheet should assess all of the natural, economic, financial, environmental, intellectual and cultural assets against all the natural, social, economic and demographic liabilities. Initially, this will, of necessity, be a major, multi-disciplinary task, but will only require a modest on-going investment. If successful, it would change thinking towards how budgets can raise the chances of a lasting prosperity, rather than how to find income to spend, regardless of the source.

A national economic accounting commission could be set up which would initially work on compiling a national balance sheet that would be updated annually. It would be independent, with commissioners who are multi-disciplinary experts from the fields of auditing, environment sciences, economics and law. As the skills required to perform this work are similar across countries, such a commission could carry out work for more than one country and, perhaps, over time a regional commission and a regional statistics institute may emerge, providing even greater independence and international comparisons, as well as economies of scale.

A national balance sheet would serve as the touchstone to craft all tax and expenditure policies as well as land use, town and country planning restrictions and permissions, and environmental policies and levies. As a first step, there would need to be an assessment of existing tax and regulatory policies to ensure they are not effectively subsidizing the consumption of non-renewable resources — except in special circumstances. Arguably, the Trinidad and Tobago economy is based on a substantial energy subsidy that has led to a distortion towards energy-using activities. The balance sheet approach would also encourage energy and resource conservation, although governments should be wary of putting too many eggs in one technology basket.

It would be vital to ensure that this approach is not abused by those promoting undisciplined economic policies on the grounds that they are supporting some intangible worth. Much can be achieved in considering the national capital stock, rather than merely the flow of income, without needing to rest decisions on an assessment of intangibles. National assets need to be valued on a conservative assessment of the income they generate or save, or have been shown to generate in a comparable situation.

### Other Environmental Initiatives

One enabling approach to environmental conservation would be to adopt technical and fiscal steps to allow “net metering,” which would allow consumers to not just pay for taking energy out of the grid, but also earn money from putting it back. Governments could support electricity companies to make such an offer by subsidizing part of the difference between the price for paying-in and the marginal cost of power generation. Net metering would incentivize both households and corporations to experiment with different technologies and methodologies. Germany has shown that the problem of energy conservation is as much fiscal as technical, when, for a brief period after net metering, it became the world’s largest user of solar voltaic power. These fiscal incentives also created a lasting comparative advantage for Germany in alternative energy technologies.

## International Financial Services Sector

### IFCs and the International Financial Crisis

One of the responses to the credit crunch of 2007–2009 was increased pressure from large countries with big financial

centres on small countries with IFCs. These countries were characterized as tax and regulatory havens with detours designed to get around rules, as sources of risk and as generally uncooperative jurisdictions.<sup>58</sup> The targets of these attacks were often relatively large “zero-tax regimes” such as Liechtenstein and Switzerland.<sup>59</sup> But the attack on IFCs also reverberates strongly throughout the Caribbean (and the Pacific nations), as it has the highest concentration of significant IFCs.<sup>60</sup> Over the past 20 years, for many Caribbean countries such as the Bahamas, British Virgin Islands, Cayman Islands, and Turks and Caicos, international financial services represented the largest single source of GDP, tax revenues and employment. For other jurisdictions such as Anguilla, Barbados and St. Kitts, international financial services represents the second single-most important source of GDP, tax revenues and employment. By some measures, the Caribbean is the fourth-largest banking sector in the world.<sup>61</sup>

There is a strong historical context to these jurisdictions, many of which are British, French or Dutch overseas territories, and have long-held preferential tax

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58 The Organisation for Economic Co-operation and Development (OECD) says that it considers three factors when deciding whether a jurisdiction is a tax haven: imposing nil or only nominal taxes and offering themselves, or are perceived as offering themselves, as a place to be used by non-residents to escape high taxes in their country of residence (this is a rather broad and hard to objectify criteria); protection of personal financial information through laws or administrative practices under which businesses and individuals can benefit from protections against scrutiny by foreign tax authorities, which prevents the transmittance of information about taxpayers who are benefiting from the low-tax jurisdiction; and a lack of transparency in the operation of the legislative, legal or administrative provisions (also broadly defined — for example, try asking French authorities for tax data on its residents who may have previously been residents of Caribbean countries).

59 In November 2010, the UK government claimed to have recovered some US\$5 billion through new tax information agreements with Liechtenstein and Switzerland signed in 2009, see the *Financial Times*, November 13, p. 3.

60 In February 2009, France placed eight Caribbean nations on a blacklist of 18 countries, branding them as uncooperative offshore financial centres. The list included St. Kitts and Nevis, Belize, Anguilla, Dominica, Grenada, Montserrat, St. Lucia, and St. Vincent and the Grenadines. This was despite the fact that many of these countries have tax agreements with OECD countries or will have them once OECD countries implement them. The French government passed a law that domestic companies that have any established commercial connections with the 18 countries on the tax haven blacklist would see a 50 percent tax imposed on dividends, interests, royalties and service fees paid by domestic firms to companies operating in those countries.

61 Measured by asset holdings by domicile. Private sector holders domiciled in the Caribbean are the single-largest, overseas private sector holders of marketable US government and agency securities, see Federal Reserve Bank of New York.

arrangements with Canada. The rise of financial sectors often mirrored the decline of the sugar industry in the 1980s and 1990s in these countries. The development of tourism and financial services in the Caribbean as an alternative to sugar, bananas and other agricultural products threatened by Latin American competition, was generally encouraged and certainly not challenged as a development strategy for the region by multilateral development institutions.

### The Economic Role and Rationale of Caribbean IFCs

The Caribbean should defend and develop their IFCs for a number of reasons, not least because it makes strong microeconomic sense (DeLisle, 2010 and A. Persaud, 2009). In the Introduction, it was argued that small and distant states should be exporting weightless professional services. The most high-value-added weightless professional services are those that surround financial centres: asset managers, family offices, lawyers, accountants, asset-valuers, risk managers, financial educators and software developers. Finance can be scaled up without extra land and labour. The amount of labour and land required to manage a US\$1 billion investment strategy is almost identical to the amount required to manage a US\$100 billion investment with a similar strategy, yet investment fees are not discounted for the size of the investment fund; indeed, fees are often higher when the fund is more popular. The same does not hold true for agriculture, manufacturing or many of the labour-intensive professional services such as medical diagnostics or architecture. This unusually flat finance industry supply curve makes it perfect for small states and, with their small public expenditures in absolute terms, allows these jurisdictions to charge low marginal tax rates for financial businesses, without these taxes representing an effective subsidy.

It also makes economic sense for large economies to let international finance migrate to specialist small states. A large financial sector has a similar effect to the Dutch disease.<sup>62</sup> It bids talent away from other sectors and pushes up wages across the economy to levels in which few remain internationally competitive. A large financial sector is more able to capture regulators and policy makers, to persuade governments of the need for bank bailouts and for preferences or concessions as occurred in the run-up to the last financial crisis in the United

62 The Dutch disease is an idea that links the effect of financial and goods markets of a natural resource and the decline in the rest of the economy. See “The Dutch Disease” (1977).

States, the United Kingdom and other large developed economies. In short, a large financial sector distorts the real economy. It is, therefore, better located and exported from places around the world where there is less “real economy” to be distorted, with the importers applying strict regulation on its consumption by their vulnerable consumers or where the size and pace of financial flows represent potential, systemic risk.

### The Challenge to Caribbean IFCs

Large financial centres do exist in large states and are significant sources of employment, revenue and patronage — they are not going to roll over and die. The path of IFCs will be determined more by international politics than international economics. Blaming “foreigners” for taking “our” jobs or evading taxes always makes for good national politics. Large states argue that IFCs “beggar thy neighbours” with permissive tax rates and regulation; they then demand that small states harmonize tax and regulation in a way that would squeeze the breath out of them.

The attacks on IFCs are not without any justification. Some jurisdictions are indeed more co-operative than others. In general, however, these attacks amount to a non-tariff barrier against competition from small states. Support for this view comes from the observation that the attacks are discriminatory. The largest “tax havens,” such as the US states of Delaware, Nevada and Wyoming, are quietly left alone.<sup>63</sup> The attacks on small states ignore the subsidies provided by large states across a range of sectors, which cannot be matched by smaller states — for example, state support to the car industry (B. Persaud, 2002). Of course, these attacks are disproportionately harsh on small-state IFCs, given the relative lack of regulatory failure in these states. It is also a serious lapse of natural justice when conclave of large countries, such as the Group of Twenty (G20) or the OECD, appoint themselves as both judge and jury on the activities of non-members and proceed to apply strictures to others while simultaneously resisting broad application of the same rules to themselves. The G20, for instance, set themselves up as judge and jury on what they define as “non-co-operative states,” but provide no sanctions if one of their own members does not meet commitments made on macro-policy.

63 Wyoming, Nevada and Delaware not only have minimal tax rates for international business, they do not require any proof of identification to set up a business, and another 26 US states allow a limited liability company to be set up without showing beneficial ownership. Although these states offer complete tax information exchange to any jurisdiction that wants it, the joke is that they don’t collect any tax information to share.

There is, on the other hand, no escaping that 20 years ago, the drivers of IFCs were competitive taxes and regulation — in the same way that the City of London captured the Eurobond market from New York through low taxes 40 years ago, and the hedge fund and private equity market 10 years ago. (It should not be forgotten that “light touch regulation” was London’s boast for over 10 years.<sup>64</sup>) Whether or not the attacks on small-state IFCs are justified, they have been made and they will continue, given the fiscal challenges in developed countries. The realpolitik is that low taxes and light regulation can no longer be the basis for growth or even the survival of IFCs.

Going forward, the quality of regulation and people will be the critical drivers of IFCs. To argue that a high standard of regulation and a highly qualified workforce will be key going forward, is similar to arguing for peace and love. No one will object, but the reality is more complex. Large countries will demand that the IFCs must meet their standards, notwithstanding the monumental failure of their previous standards. While this does not seem so unreasonable at first blush, these standards are deliberately not risk or size tolerant.

Jurisdictions where the likelihood of money laundering, for example, is slight due to exchange controls or illiquidity, are already required to invest heavily in anti-money laundering (AML) institutions, staff and training, in order for their banks to have correspondent arrangements with other international banks and without which, trade finance would be virtually impossible. The threats to support non-compliance are meaningful. Conveniently ignored is the fact that the largest incidents of money laundering have been uncovered in large metropolitan centres<sup>65</sup> and not in small-state IFCs. However, it is small-state IFCs that are required to make the largest proportional investment in AML. Through these non-tariff barriers, the size advantage offered by finance’s scalability is neutered by the disproportionate cost small states pay to match the regulatory standards required by large states. This is not

64 From a quote by UK Chancellor Gordon Brown: “...and now the determination of the financial services authority to extend their risk-based approach of financial regulation that is both a light touch and a limited touch.” (December 2005, available at: [www.hm-treasury.gov.uk/1847.htm](http://www.hm-treasury.gov.uk/1847.htm)).

65 In 2005, The Bank of New York settled with US regulators for US\$38 million regarding the largest money-laundering scandal in history, which broke in 1996. The illegal operation involved two Russian émigrés — one who was a vice president of the bank — moving over US\$7 billion via hundreds of wires. Former President Noriega is being held in France for laundering drug money through Paris. In 2010, the Vatican Bank came under investigation for alleged money laundering between Rome and Frankfurt.

to say that Caribbean countries should not invest in AML, especially those such as Jamaica and Trinidad and Tobago where drug lords are well established, but that the efforts made to limit an activity should be proportional to the size of the activity.

In the year before the financial crisis, the UK’s Financial Services Authority spent US\$2 billion on financial regulation annually and employed over 2,000 people — all to little avail, given that at one point in 2008, the entire banking system was effectively government guaranteed. Substantial expenditures and “ticked boxes” do not guarantee effective regulation, but they do represent an effective barrier to entry for small, developing countries to the IFC playing field.

The path currently being offered to small-state IFCs is not a viable one. Even if an IFC in a small jurisdiction had the resources to spend on the regulation of risks it is not vulnerable to, trying to imitate IFCs in the large centres will always make these IFCs second best or worse, in a world where customers have the ability and technology to access the best. In response to this, some Caribbean IFCs at the 2010 EU/Cariforum meeting in Antigua suggested they would have to operate, explicitly, outside of the international regulatory system. This is not a viable course of action either; it most certainly does not afford any room for growth in the new world environment. These countries need a real alternative.

### A Viable Growth Strategy for Caribbean IFCs

The only workable strategy for small-state IFCs is a niche strategy. IFCs should identify those sectors where there is a clear and credible advantage, and focus on being world-class in those areas. There are more opportunities in this space for the bold than might be imagined. While trading operations of investment banks need to be located next door to the trading operations of their competitors (allowing them to trade staff and share technologies and practices) and, therefore, they are concentrated in a few financial centres in the world — New York, London and Singapore — the location of asset management firms is driven by their most important asset — their employees and their lifestyle location choices.

This is why asset management in the United States, for example, which used to be concentrated in Manhattan, New York, Boston, Massachusetts, and Chicago, Illinois, has now branched out to Denver, Colorado, Newport Beach, California, and Fort Lauderdale, Florida. It is also why asset management is often located in the second,

less-crowded, more livable city of many countries, such as Edinburgh in the UK, Munich in Germany, Geneva in Switzerland and Melbourne in Australia. Arguably, many Caribbean countries could be a destination of choice for asset managers if they had the appropriate regulation, especially those that have extensive air connections to key markets as a result of their tourism industry and good broadband connectivity. The revealed preference is that many wealthy, private investors already physically manage their funds from their second homes in the Caribbean.

There are opportunities for Caribbean IFCs in regulatory fields as well. The primary purpose of financial regulation is to avoid systemic risk and to protect vulnerable consumers. However, in an attempt to limit regulatory arbitrage within large and complex financial systems or because, in response to political pressure, regulators have been given too many legitimate, but not strictly financial risk objectives, many of the activities that do not pose systemic or consumer risks are inappropriately regulated in large countries.

IFCs in small states can identify these areas and offer specialist regulation that is neither light nor heavy, but right-sized for the systemic risks involved in a particular activity. For example, Bermuda is effectively trying to do just that as a leading innovator in the world of captive insurance. The Cayman Islands, with stiff competition from Hong Kong, is trying to be the world-class specialist regulator of hedge funds. Barbados could be a specialist regulator of wealth management by family offices — though it will need to catch up with Singapore. Trinidad and Tobago could be a world-class specialist regulator of energy investment funds since risks in the energy-related sectors are sufficiently different to warrant a distinct type of risk management than that provided by traditional funds. Caribbean IFCs will, however, have to take regulation seriously, as they will not be in the game of imitation, but in the game of innovation if they are to succeed in the niche market. This will require investment, especially in people and advocacy.

### International Institute of Risk and Regulation

If the Caribbean is to be a leader in some areas of financial regulation, it will need world-class training capacity in financial risk, training people to an internationally

recognized standard of excellence. The region also needs to be a centre for globally renowned thinking, to help governments and regulators articulate and advocate their specialized regulatory regimes to the Financial Stability Board, the Basel Committee, the International Organization of Securities Commissions and other international regulatory bodies. Hiring senior people from large centres who have been passed over for the top job at home, is unlikely to make the region an innovator in regulation. Training local people will play a critical role in deepening the development of international financial sectors. On a national level, these sectors are viewed in terms of tax revenues and the services that come from assisting these businesses and their expatriate employees, rather than in terms of creating career-advancing opportunities for local citizens. Compare this perception of international financial service sectors with that of countries such as Singapore, Hong Kong and Mumbai, where locals run the subsidiaries of international firms and move up to senior management jobs at head offices.

Research, innovation, education and training initiatives, especially on a scale that is world-class, is best done by a regional institution. While UWI would, therefore, be considered first, the practitioner orientation of the work, and the international credibility and standards required in fields in which the university currently has little standing, suggests a range of options should be considered, including a separate institute that could have a collaborative relationship with UWI or the Caribbean Centre for Money and Finance (CCMF),<sup>66</sup> which is itself connected to UWI. After some initial assistance to establish

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<sup>66</sup> CCMF was formally launched in May 2008. It evolved from the Caribbean Centre for Monetary Studies (CCMS), but has a broader financial sector mandate and additional contributions. The CCMS was established in May 1995, to carry forward the work of the previous Regional Programme of Monetary Studies. This program was established in 1968 as a partnership between the central banks of CARICOM, UWI and the University of Guyana. The aim was to facilitate high quality research in monetary, financial and central banking issues in the region. The CCMF has recently incorporated new focus areas such as investment, securities, insurance and other financial sector issues.

such an institution and its reputation,<sup>67</sup> the institute should be able to move quickly to being self-sufficient, as both regulators and the industry have made substantial budget commitments to training. The lesson of the RRC in agriculture discussed earlier, where the university-based research centre lost touch with the industry, should not be forgotten.

## Regionalism and IFCs

While training can be regional, the regulation of IFCs should not be. Nations will be competing against each other to be the best location for certain niche businesses. A regional body would only make sense if one standard set of rules could be applied to all sectors and the enforcement costs were spread proportionately across the region. This is exactly what the large competitors hope the Caribbean will do. This is a game at which the large IFC states feel they can beat the developing-state IFCs, given their greater ability to throw money at enforcement. However, as discussed above, the successful future of IFCs in the Caribbean would be as specialist regulators, where the rules would be different than elsewhere in certain activities. As an example, it would make no sense for Bermuda, which has a global reputation in insurance regulation that attracts international insurance business, to tie itself to a regulatory body outside of the country with constituents in jurisdictions that have inferior reputations and, perhaps, a lesser understanding of, and exposure to, that industry. This would also apply to the Cayman Islands and its hedge fund industry.

Moreover, the governance and funding of a regional “super” regulator would be fraught with difficulties, in large part fuelled by significant national disparities. The investment that the Cayman Islands would be willing

to make in the regulation of international finance given the importance of this sector to its economy, would be vastly different from what Jamaica, Trinidad and Tobago, Guyana and others would be prepared to make for a sector that is only marginal to their economies. Subsidiarity of IFC regulation makes sense in the Caribbean. This is quite different from the regulation of domestic financial sectors and institutions with cross-border exposures and regional activities. In that space, international norms exist and the scope for international competition in the regulation of domestic finance is less fierce. A regional regulatory body, over and above greater regional information sharing, would be a worthwhile consideration.

## Regionalism

In this paper, it is argued that there is much that Caribbean countries can do at a national level to boost competitiveness, and small countries must strive for global competitiveness and the implementation of international trade agreements. Is there also a role for regional initiatives? The preceding discussion highlighted five key areas in which regional initiatives are sought:

- Improving global competitiveness by aggressively pursuing regional competitiveness;
- Raising the quality and impartiality of governance;
- Integrating transport and other communication infrastructure;
- Convergence of the regulation of domestic and regional finance; and
- Developing regional centres of excellence in research and innovation in finance, agriculture and other areas.

## The Regional Market

One way to make Caribbean firms more competitive is to increase their exposure to competition, not to increase their protection from competition. The sudden exposure to the cold winds of global competition might possibly do more harm than good, but trying to slowly open the door to competition has only served to keep it shut; temporary mitigations easily become lengthy procrastinations. An effective means of sequencing greater competitiveness could be to gradually open up to global competition — as negotiated under the EPA — and aggressively open up regional competition (Dookeran, 1998) in accordance with

<sup>67</sup> In 2009, the Government of Barbados, applying an EU grant, awarded a consulting project to Frankfurt University to develop the idea and curriculum of a regional institute to train regulators and financial practitioners in practical issues surrounding the management, regulation and compliance of risk. The consultants worked closely with a number of stakeholders, but the project appears to have stalled as a result of a change in personnel and the differing interests of the stakeholders. It would not be unfair to say that UWI would prefer the institute to be a university body, but the university has no reputation in this field. The government appears to lack ambition and has narrowed its objectives to a training program for two to three regulators per year. It is not really looking to push an institute of international repute, scope and scale. The Barbados International Business Association have offered private-sector sponsorship of an institute that has a practitioner focus and staff of high repute, via commitments of students, but they do not have the resources to be a seed investor or any experience in promoting such programs. Someone needs to grasp leadership and take a bet on the marketplace and the social externalities of the region matching its financial sector aspirations with a regional institute with international repute.

the Revised Treaty of Chaguaramas.<sup>68</sup> Not all countries will be evenly aggressive in opening up to regional competition, but trade theorists point out that the benefits to trade do not require trading partners to be uniformly open.

Calling on regional leaders to act on what they have already agreed to do, but has not yet happened due to national politics (Bernal, 2006), is neither easy to do nor a uniquely Caribbean problem. The experience of European integration taught that the enforcement of regional competition rules could not be left to national states. The EU achieved its goals through the full might of the European Commission's enforcement powers. The Caribbean needs the equivalent of activist European commissioners such as Mario Monti and Karel Von Miert, to sit in a regional competition authority, which has real teeth to enforce CARICOM treaty obligations. Effective regional competition must be backed by legal regulations and wide enforcement powers, including fines for the most serious competition infringements. Such an oversight competition organization must also be given powers to be proactive in shaping future competition policy — particularly with regard to cartels.<sup>69</sup> The sharpest teeth of such an authority would be its power to fine companies for non-compliance or attempting to distort or unfairly dominate national or regional markets.

Establishing such an organization, with the requisite resources to be credible and attract the appropriate staff, would be easier if its initial funding was not part of the debate as to whether one was needed. Funding a regional competition authority would be a more effective way of spending some of the resources allocated to improving the region's competitiveness than subsidizing inherently uncompetitive businesses.

68 The original Treaty of Chaguaramas established the Caribbean Community and Common Market, later known as CARICOM. It was signed on July 4, 1973 in Chaguaramas, Trinidad and Tobago. A revised Treaty of Chaguaramas establishing CARICOM, including the CSME, was signed in 2001.

69 In 1999, European Commissioner, Karel Van Miert, introduced Council Regulation 1/2003/EC on the Implementation of the Rules on Competition Laid Down in Articles 81 and 82 of the Treaty. This modernization of the regulation gave the commission new inspection powers, such as: the power to seal any business premises and books or records for the period of and to the extent necessary for the inspection; the power to ask for oral explanations of facts or documents pertaining to the subject matter and purpose of the inspection; and the power to enter non-business premises when a reasonable suspicion exists that books or other records relevant to the inspection are being kept in those non-business premises. These new powers of investigation were coupled with increased fines for breach of the obligation to cooperate during the commission's inspections.

Small states have to be in the business of importing and exporting people, experiences and skills. Of course, free movement of people, even within the Caribbean, remains a politically sensitive subject, just as it is in other regions in the world. Competitiveness, however, will be well served if CARICOM fell short in the free movement of people, but achieved the free movement of goods and capital. In the case of capital, there is room for a number of regional initiatives, such as a regional stock market<sup>70</sup> and a regionally agreed protocol on the rules and regulations that would apply to cross-border mergers and acquisitions and investing.<sup>71</sup>

### The Quality and Impartiality of Governance

Another important area in which regional initiatives can spur competition is in the sphere of governance. In small states, like small villages, it is hard to find individuals who do not have conflicts of interest. Everyone is related or connected in some way. This undermines the perception of impartiality and predictability of legal systems and frequently the reality. Similarly, it weakens confidence in impartial government permit, licensing and planning systems.<sup>72</sup> This is a major deterrent to investment and entrepreneurship. Regional cooperation through, for example, the regular swapping of senior judges and chief planners could play an important role to make the regulatory landscape more predictable and less vulnerable to partiality and, as a result, more attractive to new investment. The Organisation of Eastern Caribbean States (OECS) has a successful program of swapping supreme court judges between its nine member states,<sup>73</sup> and, as a result, has attained a level of confidence in the quality of

70 A regional stock exchange was suggested by Jamaica's Prime Minister Michael Manley in 1989, but, to date, it has not been established. See Dennise Williams, "Caribbean stock exchange a pipe dream — Carib expert" (2006).

71 As discussed previously, one of the things that undermined the US\$400 million fight for control over BS&T of Barbados between Neal & Massey and ANSA McAL of Trinidad and Tobago in 2007, was that all of the actors were not subject to a single set of transparent and enforced rules. National rules differ in Barbados and in Trinidad and Tobago on, for example, the trading of shares during a bid, and these national rules were undermined by actors arbitraging between them.

72 Conflicts of interest are not the only governance challenges in small states. For a fuller discussion, see Winston Dookeran and Akhil Malaki, *Leadership and Governance in Small States: Getting Development Right* (2008).

73 The OECS currently has nine members spread across the Eastern Caribbean. The two most geographically isolated members, Anguilla and the British Virgin Islands, have only associate membership in the organization, the other seven are Antigua and Barbuda, Dominica, Grenada, Monsterrat, Saint Kitts and Nevis, Saint Lucia, and Saint Vincent and the Grenadines.

the legal justice system that exceeds expectations, given the small size of the islands.

A true test of economic enfranchisement will be when a person from a disadvantaged background with a brilliant new idea can make it a reality in the Caribbean, and not be stymied by a closed network of government regulations, banks, lawyers and competitors.

## Communication Infrastructure

Regional cooperation in communication infrastructure is key to increasing competitiveness, where the pooling of costs and the integration of plans could significantly help reduce the cost of doing business in the region. The cost of transporting goods and people across the Caribbean is high, in some cases twice or three times as high as elsewhere.<sup>74</sup> Regional airlines have struggled to turn a commercial profit,<sup>75</sup> and as a result, are often starved of the investment they need to become more commercial. There are opportunities for reducing these costs through pooled investments in air and other transport solutions, but invariably, the investment costs are not closely mapped to the beneficiaries, limiting the willingness to act. In a vicious cycle, small, fragile transport markets have led to state support or ownership of regional airlines that, over the years, have not proven conducive to investment in service innovation, further limiting market development.

Technology advances now make a high-speed ferry connection a practical option for a number of small states along the chain, but it remains expensive for any individual

country to make this investment on its own.<sup>76</sup> Moreover, countries invested in regional airlines are hesitant to fast track this or other alternative transport projects that may undermine the fragile air transport market by fragmenting an already small market.

The physical infrastructure of laying a gas pipeline from Trinidad to Barbados would be prohibitively expensive, but would make economic sense if the cost was spread across a number of larger islands up the island chain, most notably, Martinique and Guadeloupe. The pipeline could also be used as a piggyback for other physical connections, such as fibre optic cables. Currently, this is primarily a private sector initiative<sup>77</sup> that is struggling with a number of public sector issues, such as convincing consuming countries of the security of supply, and negotiating these issues across a number of publicly owned utility companies. Having a more regional governance and finance component for the project, may assist its progress and more closely align the regional benefits.

The completion of the Takutu River Bridge and upgrading the Lethem road to an all-weather surface, both of which connect Brazil to Guyana, and the development of a deepwater port near Georgetown, Guyana, could be catalytic in opening up the Latin American market to the Caribbean region as a whole, reducing the cost of imports. The northern region is the fastest-growing region of Brazil, and the Guyanese coast is considerably closer than Brazilian ports. The benefits to the wider region being connected are far in excess of the narrow benefits to either Guyana or northern Brazil alone, and the risk is that there is underinvestment in this project.

The multilateral organizations such as the Inter American Development Bank, the European Investment Bank and Caribbean Development Bank are familiar with these regional transport infrastructure issues. These particular projects highlight the scope for regional integration of infrastructure plans and the need for an entity to take

74 The cost of freighting goods to the United States from Guyana is 12.4 percent of the value of the exports, compared with 4.4 percent for far-more-distant East Asia. Despite being physically very close, the cost of freight to the United States from Jamaica is 5.9 percent, and despite extensive shipping routes between the United States and Trinidad and Tobago, as Trinidad provides the United States with 75 percent of its LNG imports, the cost of shipping goods to the United States from Trinidad and Tobago is still higher than from East Asia at 5.4 percent. Carmen Pagés, *The Age of Productivity: Transforming Economies from the Bottom Up* (2009).

75 Under the leadership of Chairman Jean Holder and acting CEO Brian Challenger, Liat, the regional airline, turned a small profit in 2010, the first time the low-cost airline has done so in 10 years. This result was helped by lower operational costs, lower fuel prices and a calm hurricane season. Pricing, reliability, service quality and new investment remain contentious issues. The larger, indigenous airline, Caribbean Airlines, which is headquartered in Trinidad and Tobago and recently purchased Air Jamaica, benefits from a fuel-price cap and subsidy from oil-rich Trinidad and Tobago.

76 The introduction of a fast ferry between Port-of-Spain and Tobago has shortened the journey and contributed to a trebling of the number of passengers per year from less than 400,000 in 2006 to over a million in 2010. The Government of Trinidad and Tobago recently purchased four high-speed ferries for TT\$378 million from Australian shipbuilders Austal. The ferries have a capacity of 403 passengers each. They have reduced the journey time on the Port-of-Spain to San Fernando route, where the alternative car journey is considerably longer and highly congested, but it is still proving itself commercially.

77 The National Gas Company of Trinidad and Tobago (NGC) has a minority stake in the Eastern Caribbean Gas Pipeline with the other stakes currently held by Guardian Holdings Limited, Inter-Caribbean Gas Pipeline Co. and the Unit Trust Corporation of Trinidad and Tobago.

a regional approach to the benefits of these complex projects, rather than a narrow national approach. The biggest obstacles are often not the absence of potentially attractive returns, but the size of social externalities and the mismatch of national beneficiaries and national pay masters.

### Regulation of Domestic Banks

Another potential area for regional cooperation is the regulation of domestic banking (as opposed to IFCs). This has been discussed more fully in the section Regionalism and IFCs, in particular, the necessity for regional protocols on cross-border activity. There is less scope for regional integration of the regulation of IFCs, and given the difficulty in fully separating the international from domestic financial sectors,<sup>78</sup> it may be that this will act as a drag on the regional integration of domestic finance.

### Regional Centres of Excellence in Research and Innovation

The final area with potential for a regional initiative is research. The decline of agriculture in the Caribbean was mirrored by a decline in its importance in tropical agricultural research, as explained earlier in this paper. Research that can spur innovation in the fields of tropical agriculture, tourism and financial services is a critical component to the region remaining competitive in these critical sectors.

Such research is a public good and is best carried out at a regional level and disseminated broadly across the region (Cooke, 2001). Instinct suggests this research activity be housed at UWI, the regional university. Competitiveness, however, is probably not best served by monopolies, even in research. UWI has a number of objectives, including teaching and responding to demands from government and other stakeholders, and it may be more effective to establish these specialized research institutes independently, especially where a practitioner orientation is required.

It would be important to tender regional research grants in such a way that UWI and other research providers could compete equally. UWI is not well served by being the repository for all (or most) research requests in

<sup>78</sup> Part of the pressure on small-state IFCs from developed countries is for these IFCs to remove the distinction between domestic and international sectors, so the international sector is regulated and taxed in the same way as the domestic sector.

the region, as this does not allow the university to develop its own focus, comparative advantages and to build international centres of excellence. Research and education are major “industries” that can successfully be attracted to the Caribbean, as St. George’s University in Grenada has proved.<sup>79</sup> Using research grants to sharpen the competitiveness of regional research institutes and raise their international reputation for quality can serve multiple purposes. International centres of research excellence can limit the region’s brain drain, become poles of growth and employment and can spur the local commercialization of research ideas.

### Conclusion

The real issue is not *what* the Caribbean should do, as economic realities leave the region with little choice. Where overseas markets are large and local markets small, there are few alternatives to an outward orientation and a focus on professional services such legal, accounting, diagnostic and financial, and exporting specialty manufacturing and agricultural products — for example, aged rums, specialty sugars, rare coffees and chocolates and fresh fish. There is little alternative to exporting “weightless” products such as professional services, financial and creative services, or specialty products where a large proportion of the value is in the marketing and design, when the markets are distant and overseas. Where capital is tightly held and there is a plantation legacy, there is little alternative but to encourage existing businesses to expand both regionally and globally, creating economic and political space to improve competitiveness at home by facilitating entrepreneurship and widening the route to capital. It is critical to invest in preserving and enriching the natural, built and social environment, when countries are physically small.

The debate concerns how to enable change in these directions, as the region is showing dangerous signs of sinking under the weight of excessive introspection. The Caribbean is not globally competitive, but dependent. The cost of living is high, ratcheted up by inefficient ports, monopolistic transport markets, high fees and taxes. The appearance of “openness” in trade and finance hides protectionism. Stock markets and capital markets are moribund, with the recession having led to high debt levels and substantially crowding out private investment. Now that the rest of the emerging world has shaken off excessive political uncertainty and illiberalism, the much-

<sup>79</sup> Expenditure related to St. George’s University accounts for over 10 percent of Grenadian GDP.

vaunted stability of the Caribbean is viewed more as a handicap than an asset. The evil twin of strong social partnerships is solid anti-growth coalitions of business, unions and government. Growth in the Caribbean has been on a downward trajectory for over 20 years. Reinforcing this downtrend is the movement of the talented and bold to other places. Emigration rates of the highly educated are some of the highest in the world.

The situation in the Caribbean is the way it is because it suits the people who have influence. Exhortations for change and new reports from consultants will be warmly received and promptly ignored. In contemplating lasting change, the region needs to consider strategies and instruments of change that propagate transformation, that are “disruptive” of existing structures, not in the sense of revolution, but in creating sources of unpredictable innovation that disrupt the cozy establishment, throwing up new players, innovative products and fresh opportunities. This means thinking as much about incentives as institutions; and about fostering an enabling environment, not an overly prescriptive one. The critical instruments of disruptive change are technology, the organization of government services, finance and competition. Key strategies for governments in the region include an aggressive stance towards regional competition, the national exploitation of technology, nudging new organizations of capital — without providing that capital — and developing new organizations to deliver public services that allow for greater competition in delivery and more choice for the citizen.

There are plenty of reasons to be pessimistic about the future of the Caribbean, but there are also many reasons to be optimistic: the region boasts tremendous resilience and creativity, as well as having one benefit of size, which is that small states can make changes that will have impact in a relatively short space of time.

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kdias@cigionline.org  
(1 519 885 2444 x 238)

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57 Erb Street West  
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