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Open Markets for Increased Caribbean Competitiveness

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I. Introduction

The world has seen a significant increase in global private sector activity and investment. The Caribbean has not yet taken advantage of this growth. Long-term resource flows from private sources to developing countries have increased dramatically during the 1990s. All the increase has come from private sources that now account for 86% of these flows. Caribbean countries have also benefited from an increase in external flows, at a slower pace then the rest of the world. Countries in the region continue to be largely dependent on official development finance that are the source of 56% of the flows to the Caribbean, down from 73% in 1990. The slower trend in the growth of foreign direct investment should be cause for concern in the region because it will also necessarily lead to stagnation in employment and income levels.

Although the 21 million citizens of the Caribbean attract, on a per capita basis, relatively large amounts of foreign direct investment, in most Caribbean countries there has been stagnation in investment rates and in three there has been a secular decline in the investment rate. Given the greater global availability of capital, the stagnation in the Caribbean mostly reflects a lack of demand and opportunities for private investment, rather than shortages in the aggregate supply of financing. The countries need to reposition themselves to attract a larger share of global investment flows and to capture a larger share of trade in services to continue to increase the welfare of their citizens. This is feasible, and can be achieved by strengthening foreign and domestic investors' confidence through swift and credible action to improve the framework for private sector development and supporting infrastructure.

An adequate macroeconomic framework is a necessary condition for private sector development. Most Caribbean countries have in place

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adequate macroeconomic frameworks. In many aspects, the Caribbean macroeconomic frameworks and the countries' history of economic and political stability score better than that of their Latin-American neighbors. However, the international assessment of the economic environment as shown by the sovereign credit ratings in Table 2 is relatively low. These ratings try to measure the risk of doing business with a particular country and the likelihood of being repaid for any financing that has been provided and exclude project and commercial risks of specific ventures. The ratings are an indication that Caribbean countries need to strengthen their reform efforts to improve their business environment to facilitate investment by local investors and foreign investors. With the exception of Trinidad and Tobago, Caribbean countries find themselves in the middle to low end of the ranking for countries in the Latin America and the Caribbean region. The risk of natural disasters and the concentration in the sources of income certainly explain part of the ratings of Caribbean countries. However, the ongoing reform process in the other countries and the determination they have shown to live by the rules that they have set for themselves is also a significant factor in improving their standing.

Table 1 – NET LONG-TERM RESOURCE FLOWS TO DEVELOPING COUNTRIES

Year	**1990**		**1996**	
	In $MN	**As Share of Total**	**In $MN**	**As Share of Total**
Total flow	100,600	100%	284.600	100%
Caribbean	(1,196)	--	(2,150*)	--
Sources:				
Official development finance	56,300	56%	40,800	14%
Caribbean	(872)	--	(1,212*)	--
Private Flows	44,400	44%	243,800	86%
o/w to Latin American & Caribbean	(12,500)	(12%)	(74.300)	(26%)
0/w Caribbean	(324)		(938*)	
Recipients:				
Public Sector	62,800	62%	84,800	30%
Private Sector	37,800	38%	199,700	70%
Foreign Direct Investment	(24,500)	(24%)	(109,500)	(38%)
Caribbean	(562)	--	(965*)	--
Portfolio equity flows	(3,200)	(3%)	(45,700)	(16%)
Non-guaranteed debt	(10,000)	(10%)	(44,500)	(16%)
Bond	(100)	(0.1%)	(20,800)	(7%)

Source: World Bank (1997), *Global Development Finance*.

* 1995 data

Table 2 – INVESTOR CONFIDENCE AS DEMONSTRATED BY SOVEREIGN CREDIT RATING AND COUNTRY RISK ASSESSMENT FOR LATIN AMERICA AND CARIBBEAN REGION

Country	Standard & Poors Long-term, Foreign Currency Sovereign Debt Rating (April 9, 1997)	Moodys Long-term, Foreign Currency Sovereign Debt Rating (April 9, 1997)	Euromoney Country Ratings (March 1997)	Institutional Investor Country Ratings (March 1997)
Bermuda	AA	Aa1	85.96	NR
Chile	A-	Baa1	79.94	62.0
Colombia	BBB-	Baa3	63.38	47.7
Trinidad & Tobago	BB+	Ba1	59.53	39.7
Uruguay	BB+	Ba1	56.90	41.7
Peru	BB+	B2	48.19	32.0
Panama	BB+	Ba1	52.36	30.2
Mexico	BB	Ba2	64.14	42.6
El Salvador	BB	NR	49.39	23.9
Argentina	BB	B1	59.17	39.9
Paraguay	BB-	NR	54.04	32.0
Brazil	BB-	B1	59.11	38.8
Dom. Republic	B+	NR	45.36	22.5
Venezuela	B	Ba2	49.08	33.1
Barbados	NR	Ba2+	52.81	41.9
Bahamas	NR	NR	73.58	NR
Costa Rica	NR	NR	50.23	34.5
Ecuador	NR	NR	46.57	26.6
Bolivia	NR	NR	45.93	24.9
Jamaica	NR	NR	44.15	27.5
Guatemala	NR	NR	43.27	24.1
Honduras	NR	NR	37.46	18.3
Belize	NR	NR	32.56	NR
St.Lucia	NR	NR	29.77	NR
Haiti	NR	NR	28.99	11.4
Dominica	NR	NR	28.42	NR
St. Vincent & the Grenadines	NR	NR	27.17	NR
Nicaragua	NR	NR	23.32	11.9
Surinam	NR	NR	22.54	NR
Guyana	NR	NR	20.39	NR
Grenada	NR	NR	19.90	12.9
Cuba	NR	NR	10.35	10.8
Antigua & Barbuda	NR	NR	6.56	NR

Sources: Standard & Poors (1994); Moodys, Euromoney, and Institutional Investor (1992)

The countries not listed, due to the lack of information from the mentioned sources.
The scale for Euromoney and Institutional Investor country credit ratings range from 100-0. The highest possible score is 100 and the lowest possible score is 0.

II. Issues

This report briefly examines the enabling environment for achieving sustainable private sector led growth in place in the Caribbean region, and suggests some of the reforms that are required to reposition the region to take advantage of the opportunities that have arisen from changes in the global economic environment. The suggested reforms could cover numerous institutional development areas including improving incentive and regulatory frameworks, simplifying tax structures, eliminating duty and tax concessions, speeding up decisions on investors' applications, increasing labor and capital mobility, eliminating trade controls, removal of foreign exchange controls and implementing currency convertibility. However, the creation of an overall business environment which can be perceived as transparent and non-discretionary is much more important than individual actions. Only when entrepreneurs perceive an even playing field where profits arise from market opportunities and not from granted privileges, can there be sustained private sector led economic development. The report's objective is not to prescribe a development path for the Caribbean but rather to generate ideas, stimulate discussion, expand perspectives, and present options for action. To allow for a more concrete discussion of the reform agenda, the report ends by proposing in some detail to further open up the infrastructure sector to private provision, and improve the enabling environment for non-tourism services.

While Caribbean countries face important challenges they also face a great opportunity to become successful economies. Most are endowed with a relatively well-educated population and a long tradition of democratic government with mature political institutions. Private sector activity has flourished throughout most of the countries over the past two decades. Many have substantially improved their economic management in recent years. Each country has followed its own macroeconomic policies and in some cases, established far-reaching reform programs. Since the late 1980s, several Caribbean countries have floated their currencies, allowed the market to determine interest rates, removed price controls, and substantially reduced trade barriers. However, these important policy reforms need to be buttressed by additional reforms to ensure that Caribbean countries address a number of key issues which are essential to achieve their development objectives.

Caribbean societies need to forge a consensus on the state's role in pursuing a sustainable private sector development strategy. Governments, the private sector and trade unions are trying to achieve economic and social progress but in some countries discussion among them largely centers on how to split the economic pie rather than on expanding it. Past failures to achieve such a consensus in some of the Caribbean countries led to stop-and-go reforms with episodes of macroeconomic instability, unavoidable in such circumstances, interrupting and usually unraveling reforms. The historical record demonstrates that distributive goals can best be achieved in a growing economy; with efficiency gains, productivity increases, and general economic expansion being much more likely to be achieved where productive activity is in the hands of the private sector.

Caribbean governments need to reexamine and redefine the role of the public sector in the economy to lower high tax burdens, improve the quality of public expenditure and services, devote their resources to the provision of those services that the private sector cannot currently supply effectively, encourage the domestic and foreign private sector to sustain investment flows, and lend credibility to macroeconomic policy through clearly stated objectives, consistent policy action, and privatization of state-owned companies. This is not an ideological recommendation, for the public sector in most high income countries is larger relative to national income than in the Caribbean. Rather, it is a practical consideration, so that the scope of public sector activities matches the availability of resources and for improving the performance of the public sector.

The choice of the role of the public sector should recognize the options for partnerships with the private sector. Management, financing, and ownership are separable functions that can be allocated as appropriate to the situation. Privatization will be an important vehicle to achieve increased efficiency, to modernize the Caribbean economies and to signal the changed approach to economic development.

Governments need to credibly establish that their reforms are real and permanent. In many Caribbean countries, enterprises find delays in processing investors' applications, administrative requirements, discretionary public sector interventions, high taxation levels, and policy uncertainties as the main obstacles to increasing investment and expanding production. Although many enterprises have been favored by discretional government interventions, these interventions have sometimes increased the uncertainty regarding the rules of doing business and directed significant resources into unproductive activities. Reforms will only be perceived as permanent when governments cease to discretionally try to influence the outcome of the activities of individual enterprises, close the gap between the openness message they send and the perception about their actions, and eliminate the involvement of the public sector in commercial activities.

Product markets need to become more competitive and factor movements more flexible across sectors and countries. Previous inward-looking strategies have created protected oligopolistic firms. The latter, together with large public employment and borrowing have limited labor mobility and private access to capital markets. Incentives to increase competition and allow factor markets to become more flexible would enhance the effectiveness of macroeconomic policy, attract investment, and enable the economy to better withstand external shocks.

Institutions need to be strengthened to reduce the costs and risks of doing business. All governments manage social and economic activity by defining rights and obligations of private and public agents through laws and regulations. Risks flowing from these actions are not confined to developing countries and include changes in economy-wide laws and regulations (e.g., environmental standards, import/export regulation and taxation; and uncertainty over the application of industry – or project specific regulations, including the possible exercise of regulatory discretion in a manner unfavorable to the investor, or the repudiation by government of specific contractual commitments on regulatory issues. A key challenge is to strike a balance between specific and rigid rules that can reduce the risks and costs of investment with more flexible approaches that make it easier to provide incentives for efficiency and to adapt to changing conditions in long-term arrangements. Options to address this issue include adopting more competitive market structures and establishing institutions that enjoy some insulation from political interference.

Modernized public administration and good governance, including an efficient public service, reliable judicial system and accountable administration, are requisite for a dynamic economy. Reforms of existing institutions like the tax and customs administration are key steps towards the development of a more dynamic private sector. Investors want clear, published, non-discretionary, and well enforced regulations that provide adequate protection against breaches of contract or abuses, but that also allow desirable investment on a routine basis. Systems and procedures need to become transparent, and laws need to be changed to reduce transaction costs, allow for contracts that are simpler and easier to enforce, and encourage entrepreneurship in the Caribbean countries.

III. MARKET ACCESS

All Caribbean countries are increasingly basing their reform agenda on the private sector as the engine of growth. Macroeconomic policy reforms linked to incentive reforms, incentive reforms similarly linked to legal reforms, and improvements in infrastructure should lead to a strong supply response in all sectors. Reforms in these areas by opening up local markets and subjecting all market participants to increased competition should help raise productivity and reduce unemployment.

To facilitate market entry, entry and exit requirements should be clear. While reduction of regulation and taxes is necessary in some cases, this has already happened in many places. Some regulation and taxation need to be retained or even strengthened to preserve the fairness of competitive markets and to provide the state with the necessary resources. Governments should strive to clarify laws that affect trade and commerce in order to enable corporate managers and lenders to make realistic assessments of the risks involved in operating in particular countries. However, important segments of the private sector have a vested interest in the maintenance of much of the present body of laws and regulations existing in all Caribbean countries, which limit market access and reduce competition. Well developed privatization programs, as well as continuing trade reform, will improve the competitive environment and should be continued. The common heritage of their legislative and judicial systems puts CARICOM member countries in a comparatively strong position to harmonize company entry and exit mechanisms that could lead to the creation of regional competitive markets that would magnify the impact of single country measures.

Many English-speaking countries in the region have company laws derived from the early British legislation (e.g., 1929 in Trinidad and Tobago, and 1948 in Jamaica). But these laws do not include subsequent British amendments and have become outdated. A standard Companies Act and laws surrounding the operation of businesses are not in place for CARICOM nor in the OECS countries, although model legislation has been drafted. The bureaucratic requirements of different laws in each territory cost businesses time and money to deal with the wide range of requirements and provide protection to less efficient producers. Model legislation developed for the OECS countries should be adopted. The Barbados experience suggests that, despite the investment in learning, the transition to a totally new system can be quite smooth. Coordination of legislative reforms is not only needed within a given country; there would be considerable advantages for the Caribbean countries if they were to adopt similar laws throughout the region. The legal process also should be improved through new technology, such as for record keeping and registries, and by facilitating alternative dispute settlements, such as arbitration, mediation, and conciliation

Governments play a major role in reviewing and approving investment decisions in the Caribbean countries. While some of these activities are necessary and in the public's interest, poor administrative practices have increased the costs of doing business through delays and excessive information requirements. Also, in many countries, lack of clear criteria has reduced transparency and increased the uncertainty of doing business. Caribbean countries should strive to create a level playing field among foreign and domestic investors by opening up activities to foreign participants and avoiding incentive schemes that benefit mostly foreign investors.

For many people improving the environment for the private sector means giving special incentives. Fiscal incentives are widely used to encourage investment in sectors such as manufacturing and tourism but are difficult and costly to monitor, not sufficiently narrow in their application, and discriminatory among sectors, enterprises, and towards small- and medium-sized businesses. Consideration should be given to eliminating many of the fiscal incentives by not granting new ones and not renewing the existing ones in tandem with a lowering of tax rates. These measures, combined with the improvement of basic business conditions, would strengthen transparency, reduce the importance of non-economic factors in investment decisions, save administrative resources, and improve tax collection.

In the Caribbean region, labor mobility and access to regional labor markets is of paramount importance. Because of the size of the economies and the needs that often arise on a seasonal or temporary basis the required skills are often not available in a country's labor pool. Restrictions on non-nationals taking up employment in the Caribbean countries are a major barrier to investment and also leads to trained people leaving because they cannot get into a situation with a mix of workers to maximize their efficiency and earning power. Government policies should allow fair and speedy processing of applications for work permits. This should take into account both legitimate pressures for upward mobility among local personnel and investors' need to recruit the most suitable staff.

Caribbean businesses also suffer from the natural problems of small and fragmented capital markets. Most companies do not have access to capital markets to raise equity and debt from a large, public investor base. Thus, equity ownership is not widespread. While the technical problems are now surmountable through the use of an electronic rather than a physical marketplace, controls on foreign investment and lack of currency convertibility are the principal causes of a small and fragmented market. Other hindrances are the lack of uniformity in tax rates and systems, company law requirements regarding disclosure and accountancy standards, alien landholding acts that have an impact far beyond the ownership of land, and absence of tax treaties between Caribbean countries. Steps need to be taken to increase competition between capital market intermediaries and to remove fixed commissions.

To ease constraints in labor mobility and increase the pool of available capital, those Caribbean Governments that have not yet done so could introduce separate accounting for the social contributions for health and pensions. This would allow the introduction of individual pension accounts that would directly link contributions to benefits. For highest return and efficiency these accounts should be managed by private managers. Private pension managers would need to be able to operate on a regional basis to increase their commercial viability, quality of the service, and the impact of the reform. Labor mobility between the private and the public sector and among Caribbean countries would be enhanced because workers would keep their acquired pension rights regardless of their employer and possibly the country in the region where they are employed. The capital market would be boosted by the increased liquidity of local instruments even if a large share of the pension savings is invested outside of the region to increase risk adjusted returns through adequate diversification. In addition, this reform would aid macroeconomic stability by reducing a large contingent liability in the accounts of the public sector. However, to realize the mentioned benefits the regulation and supervision of the private pension system needs to be adequate as well as of the other suppliers of contractual savings instruments like the insurance industry.

Although some external financing goes directly into investment, much of the external financing and domestic saving goes through the financial sector. This sector has expanded rapidly in recent years, but the regulatory systems for commercial banks, insurance companies and financial institutions in the Caribbean countries are inadequate. Past failures of financial institutions in Barbados, Trinidad and Tobago, Jamaica and the Dominican Republic, harmed depositors and adversely affected confidence in the financial system. These failures were directly attributable to insufficient supervision and inadequate regulations. Banking and financial sector administration is under review throughout the region and a proposal for regional banking legislation has been drafted. There are wide variations in regional practices which must be ironed out. Opportunities for closer cooperation among supervision authorities abound given the similarity of the countries' financial systems. Achievement of a critical mass through regionalization of financial institutions, like the private development banks Trafalgar Development Bank of Jamaica and Development Finance Limited of Trinidad and Tobago, will require a common legal framework. Assistance from the formal banking system to small enterprises and the informal sector is very small. However, there are many specialized small enterprise financing schemes with lending capacity to spare. The financial systems would particularly benefit from the adoption of comparable regulations and supervision systems, including financial reporting requirements.

IV. MARKET ACCESS FOR INFRASTRUCTURE AND SERVICES

The case for improved market access in the Caribbean has been often made by many. Therefore, this report will finish by making concrete proposals in two areas that have not received as much attention, namely, the provision of infrastructure services and the development of the services industry, in addition to tourism. Both are key for the development of the Caribbean countries. At the same time, while there are specific issues for these two particular sectors, the most important ones are relevant for all sectors and economic growth in the Caribbean in general.

Governments in the Caribbean are having increasing difficulties in providing the infrastructure that their countries require for development and it is now time for them to further open up this sector to the private sector. With a history of large public utilities controlling the provision of infrastructure services it could be hard for many to visualize private enterprises providing this services in a competitive way that increases the welfare of consumers in relatively small economies. As shown in Table 3, external private financing of private infrastructure all over the developing world has had a dramatic increase. From a very small US$ 100 million only in East Asia in 1988 to over US$ 20 billion in 1996 in the world and almost US$ 8 billion in Latin America and the Caribbean. The size of a country does not seem relevant for its capacity to embark on this course. In 1996, Hong Kong signed 36 deals for the equivalent of 13.5% of GDP, Qatar signed 3 deals for the equivalent of US$ 8,563 per capita. Jamaica has also been part of this trend through private power projects.

Table 3 - PRIVATE CROSS-BORDER INFRASTRUCTURE FINANCE (IN BILLIONS OF U.S. DOLLARS)

	1988	1989	1990	1991	1992	1993	1994	1995	1996
Total:	0.1	0.9	2.0	3.5	5.8	12.3	15.7	15.6	20.3
loans:	0.1	0.8	1.4	0.1	1.5	6.3	6.0	11.1	7.7
bonds:	0	0.2	0.5	0.7	1.1	3.9	5.8	3.3	7.2
equity	0	0	0.1	2.6	3.1	2.1	3.9	1.3	5.4
LAC	0	0.2	0.3	3.1	3.6	4.7	6.6	2.1	7.8
loans	0	0	0	0.02	0.2	0.3	1.6	0.7	0.7
bonds	0	0.2	0.3	0.6	1.0	3.3	3.7	1.4	4.4
equity	0	0	0.1	2.5	2.4	1.1	1.3	0	2.8
EAP	0.1	0.8	1.5	0.4	2.0	5.7	6.8	8.8	9.3
loans	0.1	0.8	1.3	0.05	1.2	4.6	3.4	6.1	4.9
bonds	0	0	0.3	0.2	0.2	0.3	2.1	1.7	2.4
equity	0	0	0.02	0.1	0.6	0.8	1.3	1.0	2.0

The numbers in Table 3 understate the extent of private sector participation in infrastructure because they are limited to external financing and experience is showing that a large share of the resources devoted to private infrastructure is coming from local investors and because it excludes all other private participation that goes beyond investment.

The instruments for the involvement of the private sector in the provision of infrastructure services can take many forms. In some cases like telecommunications, there is no need for public funding or equity at all and in others like roads, the private participation can minimize public outlays by letting the private sector bid for the minimum payment from the public sector to build, maintain, or operate a road. The competition for the provision of these services will in large part not come from competition in the market but from competition for the market, a competition that has proved to be very successful in providing good services at a reasonable price. The role of the private sector in the provision of infrastructures is to:

- increase the efficiency in construction and operation of projects and services;
- provide additional resources to supply necessary services in a shorter time;
- reduce risks assumed by the public sector;
- obtain the benefits of competition;
- allow Government to reallocate public resources into the social sectors.

In order to achieve these objectives, the government's role in the sector has to be more clearly defined, particularly with regard to its core functions of regulation and policy-making, how it will design an efficient transition to private ownership and operation of infrastructure, and market structures that maximize competition and minimize the need for regulation and the risk of regulatory failure.

The main message of this report is that the government should push harder in three areas: divestiture of existing infrastructure assets, developing the regulatory and competitive environment within which infrastructure services are provided and ensuring that where the government does play a role in mitigating risks in private infrastructure deals, it does so in a way which minimizes the potential distortions of such actions and at minimal cost to government.

A number of outright privatization may be a useful and even a necessary way to sustain reforms in infrastructure sectors. As well as having numerous benefits in terms of increasing efficiency, reducing the fiscal drain and improving the quality of service, this could also ease the financing of new infrastructure. Privatization of electricity distribution, for instance, will allow credit-worthy entities to be created that can write credible long-term contracts with new generation entities. In water and sewerage, internally generated resources created from efficiency gains will allow greater investments to be made by concessionaires or private owners.

Private operations are, however, best provided in a competitive framework that promotes efficiency, quality of service and cost-reflective prices. Caribbean governments plan to extend competition in a number of infrastructure sectors, notably electricity and telecommunications. The competitive framework within which these services are provided is critical. As the market system evolves, privatization of existing generation plant and distributors will be important, the former to create a group of companies that will be more comfortable with investing than completely new entrants to the market, and the latter to create credit-worthy entities who can pay for the power they receive and contract with new and existing generators. In telecommunications, when the exclusivity conditions in cellular telephony and long-distance services expire, the government should consider outright liberalization of these services to allow new players to enter the market.

The question of government actions in a 'transitional' phase until the private sector becomes the dominant operator of services is a difficult one. Some forms of intermediate step such as mixed companies or 'subconcessions' between public and private companies can be problematic. Another complex issue is the granting of government guarantees and other forms of transitional support until the private sector becomes fully established as the dominant operator. The provision of some guarantees, of items which are the government's responsibility, may be important in the short-run. In the medium-term, however, the more important condition will be the divestiture of the remaining elements of the systems which are forcing the need for guarantees – e.g. in electricity the privatization of distribution will help to eliminate the need for future public support of private generation projects. In some sectors, notably toll roads, government financial support may continue to be necessary to launch projects and the key will be to minimize the potential distortionary impact of this support and risks assumed by the public sector. The negative experience of the Government of St. Vincent and The Grenadines with guaranteeing a private investment in infrastructure shows how important it is to be very clear about the risks that the government assumes.

Another part of the transitional phase is the likely increase in the number of 'mixed' companies where the shareholdings are part public and part private. Empirically, these have proved to perform badly, even in comparison with public companies. The government can, however, take actions that can minimize the negative effects through public share offerings as part of the divestiture process, setting up a trust to administer the government's holdings at arm's length and establishing a timetable for divestiture of the remaining shares.

The government in this transitional phase will also face significant issues regarding 'competitive neutrality' between public and private operators. The government of Australia has systematically examined this issue and come up with a series of guidelines to ensure that public and private operators compete fairly with one another. Some of the useful measures that the Australian government is implementing include rules ensuring regulatory neutrality, ensuring that public entities earn returns equivalent to private companies and creating an ombudsman to allow private operators to complain if they feel the public companies are using their public status unfairly. These may be useful guidelines for the Caribbean governments to analyze in sectors where the public and private sectors are likely to compete.

Regulation of infrastructure services has proved to be a difficult task, even in countries such as the US which have had over 100 years of experience in the regulation of utilities. Rules continue to evolve, competition has been introduced in sectors forcing regulators to take difficult decisions regarding horizontal and vertical restructuring, setting interconnection prices and developing a 'level playing field' for all competitors. In the short-run, the introduction of competition seems to actually increase the amount of regulation, although with the hope that once viable competitors are established and the ground rules laid out the need for regulation will diminish or disappear. In the longer-run, with more narrowly targeted objectives, greater independence to regulatory agencies could be a way to increase the confidence of private investors in the stability of the regulatory framework. Regional regulatory agencies could prove to be an efficient way to regulate, among other things because of the likelihood that they have a greater distance to the short term concerns of individual Governments.

This report recommends revisiting some of the issues with regard to tariffs for the poor. The cross-subsidy mechanism is a costly one which creates substantial distortions. If direct public funds are available, concessional funding could be targeted towards providing lump-sum subsidies to increase connection rates, particularly in water and sewerage. Direct transfers to subsidize the connection of poor customers to infrastructure networks, a relatively non-distortionary form of financing for infrastructure, would be better targeted to the poor. Likewise, where there is a concern about affordability of the basic service, a move to direct transfers to customers, for instance through vouchers provided directly to poor customers, on the lines of the schemes for subsidizing poor customers' water bills in Chile would be a more targeted and efficient scheme than the current cross-subsidy schemes.

Perhaps even more important than opening up the infrastructure sector to private provision, and like tourism in the 1980s, non-tourism service export development could help the Caribbean achieve its goals in economic growth in the 1990s and beyond. The development of an efficient services sector is increasingly recognized to be important to overall economic growth. Potential development benefits of non-tourism service export growth include employment for a range of skill levels, reduced vulnerability to external shocks through diversification, and some increase in foreign exchange and tax revenue. Consumers would benefit from availability of a wider array of services that the local market alone cannot support. Caribbean manufacturing, tourism, and other service firms that rely on intermediate service inputs, such as information and systems management services, would benefit from development of an internationally competitive service sector in the region.

The Caribbean countries have already achieved some success in specific service export areas in addition to tourism – notably, offshore financial services in Barbados, and information processing in Jamaica, Barbados, Dominican Republic and some OECS countries. In addition, there are dynamic small- to medium-sized firms that have succeeded in exporting their services. Overall, however, non-tourism services export growth in the region has not kept up with the rapid pace of expansion of the sector globally. The region's share of global non-tourism service exports has declined since 1980.

This report suggests that actions need to be taken to realize the region's potential for further service export growth. It would be difficult for the sector to flourish under current conditions. The countries of the Caribbean will have to address difficult issues constraining private sector development in general, as well as some issues specific to the non-tourism service export sector.

The market for service exports is highly competitive. The region faces stiff competition for market share both from providers in the target markets and from service exporters from other developing countries. International outsourcing of services becomes appealing to firms when the cost savings are in the order of 30-40%, such that domestic service providers in target markets still have a substantial advantage over international contenders. As for competition from other developing countries, language and time differences have not proven insurmountable barriers in many service exports. Mexico and Costa Rica have developed successful non-tourism service export industries aimed at the US market, despite language barriers. The Philippines and India export services to the

US despite distant location and lack of cultural affinity. Thus, the Caribbean's geographic and cultural advantages are not enough to attract outsourcing firms or consumers. The governments of the region will need to put in place the best possible business environment for regional firms to be able to compete.

The Caribbean countries have made important progress in liberalizing trade in goods and improving macroeconomic conditions. In addition, some actions relevant to liberalization of trade in services have been undertaken. The decision to allow CARICOM university graduates to work freely in any CARICOM country is thus far the most significant measure. A broad liberalization of trade in services, however, has not taken place. Protection and constraints on foreign investment in the sector have permitted domestic services sectors to continue to operate according to the local status quo, with few linkages to the rapidly evolving global services economy. Barriers to import of knowledge in the form of stringent and bureaucratic work permit regimes limit growth and learning, and promote isolationism rather than keeping up to date with market best practice.

There are policies constraining non-tourism service export, and private sector development in general. Investing in improving the education systems and increasing the flexibility of domestic labor markets have not been given primacy as national goals. Several countries have initiated projects in education. None, however, have tackled the rigidities in the labor markets. The structure of the telecommunications market is not consistent with long-term development of the sector. Modernizing telecommunications legislation and strengthening of regulatory capacity have not been addressed. The complexity and discretionality of the investment and incentive regimes for many service exports is discouraging to domestic and foreign investors. Inadequacies and gaps in fiscal frameworks mean that some service exports are subject to high levels of taxes and tariffs. Fragmentation of the regional market and ad hoc procurement policies have prevented increases in competition and have severely constrained development of professional services. These limitations seem to affect all the countries covered in this report, in spite of differences in development and circumstances of individual countries.

Discussion in the region of means to develop service exports has tended to focus on promotion efforts and incentives. Without the ability to deliver a high-quality, cost-competitive product, however, marketing will not be effective. In addition, incentives will not make up for fundamental constraints to establishing and operating a competitive service export enterprise. A focus on incentives specific to the service export sector could distract attention and resources from making needed improvements in the business environment. Fiscal incentives for both the service and manufacturing sector can reduce revenues available for primary and secondary education, which is fundamental to long term development of the service export sector in the region. The main source of comparative advantage in many service exports is human capital – the productivity of workers in labor-intensive services and expertise of professionals in knowledge-intensive services. Sector-specific incentives are not recommended due to consequent distortions in resource allocation that hinder economic growth. Moreover, the track record of such incentives is dismal. A more systematic approach to getting the environment right for service exports is needed.

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