A TIME TO CHOOSE:
CARIBBEAN DEVELOPMENT IN THE 21ST CENTURY

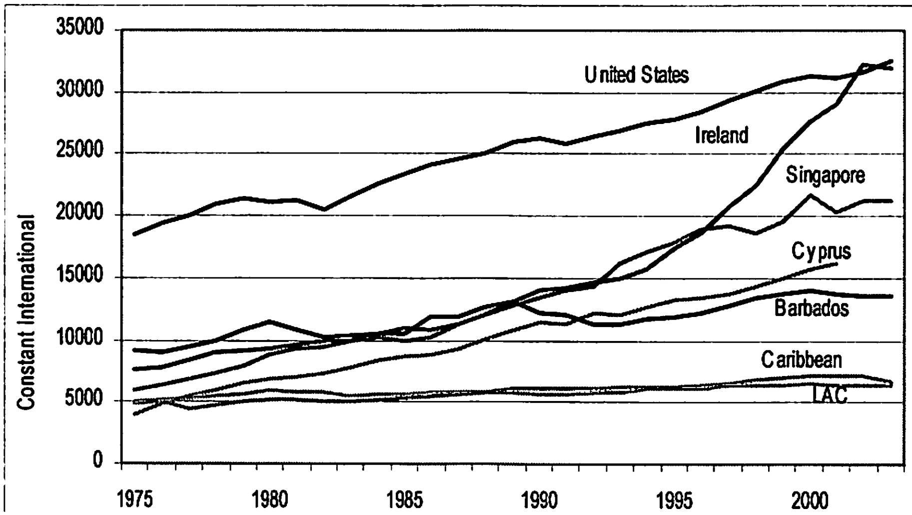
EXECUTIVE SUMMARY AND POLICY OPTIONS

1. Caribbean countries[1] face unique development challenges arising from their small size and vulnerability to natural disasters as well as the resulting economic volatility. Also, they continue to confront a changing international environment, with a significant transformation in the production structure of most economies, away from traditional agriculture.

2. Despite these challenges, the Caribbean has continued to see a sustained growth in per capita incomes, with most of them becoming middle income countries and achieving high levels of human development. These achievements reflect many of the positive endowments that the Caribbean countries have been blessed with, including favorable locations and excellent climates, virtually no hinterlands, the advantage of the English language in most countries (Spanish, French, and Dutch in other cases), an early targeting of universal primary education, strong traditions of democratic participation and political stability for most countries, and a significant degree of regional integration despite significant differences in economic and social characteristics.

3. Yet, as the 21st century begins, the abiding impression is one of under-fulfilled potential and concern for the sustainability of past accomplishments. Figure 1 below tells its own story—the overtaking of even the Caribbean's highest income countries such as Barbados (and Antigua and Barbuda), by small and comparable countries like Singapore, as well as Ireland and Cyprus, whose economic strategy was centered around achieving international competitiveness.

Figure 1: Per Capita Incomes (PPP) 1975-2002



Source: World Development Indicators (WDI)

4. Formidable challenges lie ahead. While poverty has declined in the past, it remains high in many countries, including Haiti, Guyana, the Dominican Republic after its crisis, and several OECS countries. Unemployment, particularly of youth, is a major issue; it has severe implications for poverty and the income distribution, as well drug trafficking and addiction. Migration is of course a double-edged sword, but its large scale serves as a reminder that many educated people lack access to significant economic opportunity. All this means that improving the rate and quality of growth is crucial, given the linkages between pro-poor growth and poverty reduction and employment. Another challenge is coping with natural disasters and economic volatility, as

[1] In this study, the included countries are the OECS group--Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines, as well as The Bahamas, Belize, Barbados, Dominican Republic, Guyana, Haiti, Jamaica, Suriname, and Trinidad and Tobago.

the 2004 hurricane season reminded us. Still another challenge is reducing crime, which is affecting the larger islands and increasingly the smaller ones; it impacts the social fabric as well as investment and growth, and contributes to increased migration. Meeting these challenges is complicated by the massive increase in public debt in the last few years—the Caribbean now has the dubious distinction of having many of the most indebted countries in the world. High debt makes the countries even more susceptible to volatility, increases risks of macro instability and compromises their growth prospects.

5. Fortunately, the challenges are not insurmountable, and can be dealt with, with the central plank being a focus on sustaining and improving growth and competitiveness. Of course, some of the issues highlighted above have a two-way causation, meaning they also affect growth, but it is nevertheless useful to think of growth as being the main instrument to achieve many of the social goals. Experience across the world shows that growth results in poverty reduction, and this is true for the Caribbean as well; also, for some of the countries for which evidence exists, the elasticity of employment with respect to output is positive. Thus, a virtuous circle of growth could reduce unemployment, poverty, crime, reduce incentives for migration, and create fiscal space for dealing better with disasters.

6. This report seeks to discuss the critical constraints to sustainable, job-creating growth, and to present policy options for the region and country Governments to stimulate such growth. It analyzes growth performance in the Caribbean over the last four decades, and highlights key determinants of past and also future growth. Given the recent deterioration in government finances, the report then studies key areas of government expenditure. A discussion of the climate for private investment follows, which looks at the framework that shapes the risks and returns for private investment. The report then discusses the impact of recent trade developments on the Caribbean, the future outlook in view of major ongoing changes in the international environment, as well as the opportunities that are likely to emerge, especially in the services sector. It then focuses on some key factors that have been significant in determining past growth in the Caribbean, including labor market issues; education, skill development and training; and infrastructure.

7. The report suggests a pro-active approach for the region to take on the challenges of a group of small states facing severe resource constraints, eroding trade preferences, declining productivity, and increasing risk of macro instability. *First*, it argues that greater integration within the CARICOM region on several fronts will be a critical input into improving competitiveness. Easing up further on labor mobility within the region would improve wage and skill arbitrage; joint investment promotion would make the region more attractive for investment; tax harmonization would help reduce harmful tax competition; more cooperation in provision of services and regulation could help to reduce the high costs of government. *Second*, on trade, the report argues that a negotiation of an orderly dismantling of preferences in return for increased technical and financial support would be in the region's interest. *Third*, improving the investment climate and orienting it away from being subsidy-driven, addressing problems of high taxes and inefficient customs procedures, as well as specific infrastructure deficiencies, would help improve the quality of private investment and maintain the high levels of FDI. *Fourth*, making the public sector more cost-effective and delivering services more efficiently, through greater reliance on the private sector where feasible, and seeking cost efficiencies through regional cooperation, would be necessary to reduce crowding out by Government of private sector employment and investment. *Fifth*, improving the quality and effectiveness of human resources would enable diversification into knowledge-based activities including services, increase exports, and improve productivity in existing activities.

8. One of the challenges of doing a regional report is the issue of country specificity. During the analysis, it was found that countries were often too heterogeneous to permit easy classification into country groupings. Accordingly, some generalized points made in the report for the Caribbean may not be valid for specific countries, even though the individual chapters will try to bring out specificities where possible.

9. The report naturally draws on the extensive research material that already exists in the Caribbean. However, it adds to that body of research and analysis in each of the chapters, including the analysis and projections of growth in a cross-country framework; primary data collection in a foreign investors' perception survey and a diagnostic of the investment climate in Grenada; new case studies in several services sectors (such as offshore education, health tourism, tourism, temporary labor migration and ICT-enabled services), as well as analysis of firm success stories; new work on labor markets and skill development; case studies of sugar, and SPS standards and Jamaica's agricultural exports; and a new analysis of infrastructure issues, focusing on efficiency and the quality of institutions. Drawing all these strands together, the report presents a holistic and integrated view of the critical factors that inhibit improved growth. It is hoped that the report will catalyze debate amongst the various stakeholders in society, a process that could help identify bottlenecks, create consensus and, as a result, leverage support for the implementation of reforms. It is also hoped that the report will serve as a tool to help countries develop their own national plans for development, keeping the regional dimension very much in the forefront. Further analytical work is needed, inter alia, on migration and its net impact on society, as well as on inequality and social change and its relationship with economic growth.

Reasonable past growth, but now slowing down

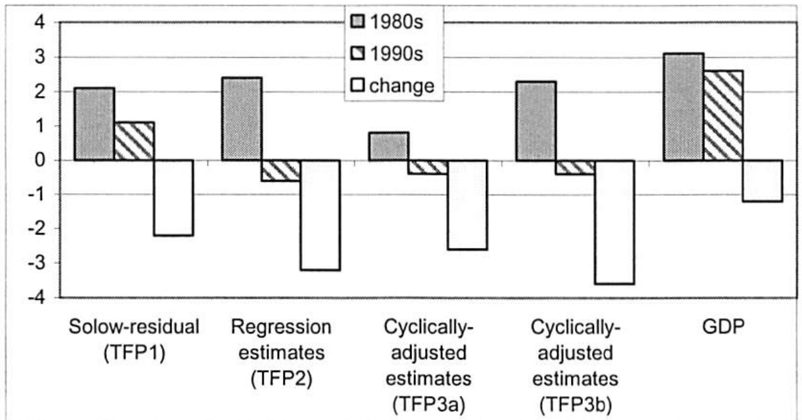
10. Between 1961-2002, average per capita GDP growth for a median Caribbean country was 2.8 percent, higher than Latin America in every decade, but lower than East Asia, especially some of the fast-growing small economies like Singapore and Hong Kong. However, this reasonable growth performance is clouded by several factors.

11. First, average growth has been slowing down in each decade since the 1970s. Average rates of per capita GDP growth in the Caribbean have declined from 4.3 percent in the 1970s, 2.1 percent in the 1980s, to 1.7 percent in the 1990s. Ten Caribbean countries suffered a decline in trend growth after the 1980s, especially the OECS countries of Antigua and Barbuda, Dominica, St. Lucia and St. Vincent and the Grenadines. The Dominican Republic, Guyana, Suriname and Trinidad and Tobago saw increases in trend growth in the 1990s, having suffered major slowdowns in the 1980s.

12. Second, the gap between the rich and poor countries within the region has widened over time, with growth performance varying more widely within the Caribbean than within Latin America. Over 1960-2002, the slowest growing countries in the region were Haiti, Jamaica, Guyana and Suriname, also four of the five poorest in terms of per capita GDP.

13. Third, there has been a sharp decline in productivity gains between the 1980s and the 1990s, irrespective of methodology employed to measure productivity growth (Figure 2). In fact, after adjustments in the measurement of total factor productivity (TFP) for short-run cyclical fluctuations, the contribution of TFP growth to GDP growth in the 1990s becomes negative (TFP3a and TFP3b in Figure 2) for most countries. After cyclical adjustment, only three countries showed a statistically significant and positive TFP growth in the 1990s—the Dominican Republic, Trinidad and Tobago and Guyana. In the 1980s, on the other hand, most estimates show a significant contribution of productivity gains to growth in the Caribbean. In other words, growth in factor inputs contributed more to economic growth in the 1990s than in the 1980s. This decline in productivity growth in the 1990s is due to several factors—the lower productivity of public investments, especially in the OECS countries, which over-invested after 1997, partly in an attempt to compensate for the decline in private investment; the locking in of investments into traditional, low productivity sectors such as agriculture, in part due to preferences and high tariffs; and the large investments in maturing sectors, namely tourism, where productivity improvements are more difficult to come by, and this applied to most Caribbean countries.

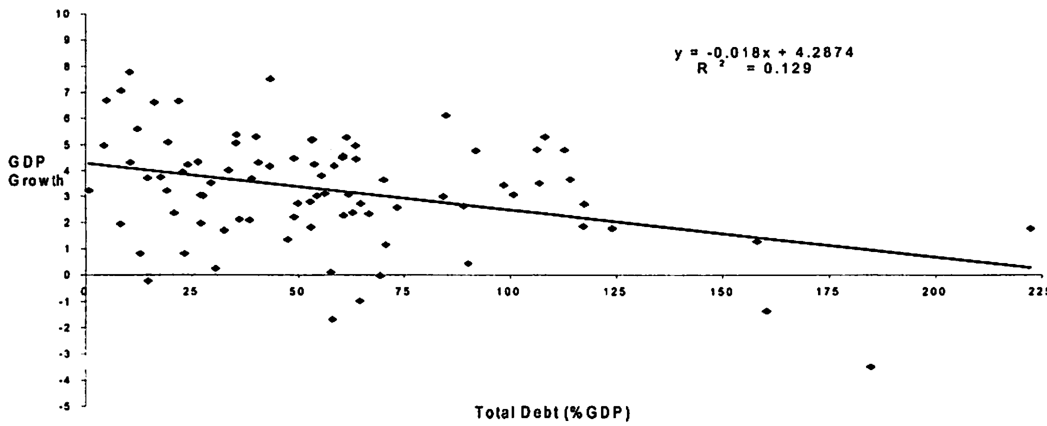
Figure 2: Caribbean Total Factor Productivity (Median Growth Rates, %)



Source: World Bank Staff estimates.

14. Fourth, there has been a build-up of debt in most Caribbean countries, in many cases to levels that test the limits of sustainability. Over 1960-2002, five of the six fastest growing Caribbean countries were from the OECS, but most of these were also those that saw the sharpest growth slowdowns between the 1980s and 1990s, and, in the most recent period, 1998-2003, OECS countries grew slower than non-OECS countries (Annex Table 1.8). This is related to the massive increase in debt in the OECS, almost doubling as a percent of GDP between 1997 and 2003, and driven in turn by increases in capital and current expenditures. In the case of other countries, notably Guyana and Jamaica, debt has been a long-standing issue. While debt has been reduced in Guyana through HIPC-related debt write-offs, Jamaica has decided to maintain very high primary surpluses (among the highest in the world) in the medium-term in order to stabilize and reduce its debt. Belize has seen an increase in its debt to 100 percent in 2003 (41 percent in 1997), reflecting takeover of contingent liabilities. The very high debt has placed 7 Caribbean countries amongst the 10 most indebted countries in the world, and 14 among the top 30. This has hurt growth in the past and the further build up of debt is likely to be even more damaging in the future, as cross-experience shows (Figure 3). Dominica has already experienced a debt crisis, and restructured some of its debt in 2004, but many other countries have debt ratios higher than or close to Dominica's.

Figure 3: GDP Growth and Total Debt (%GDP), 86 countries
(Five Yr. Averages, 97-01)



15. Fifth, past growth does not appear to have been driven by a strategic agenda for competitiveness. Rather, the dominant focus has been to try to hold on to special and differential treatment on export and import trade as long as possible, with less attention to the long-run costs of such a strategy including foregone economic opportunities (see below and Chapter 4).

16. The implication is that if current policies continue, future prospects are more uncertain, for many of the reasons discussed above, including the slowdown in growth, the decline in TFP, the increasing macro vulnerability, and the lack of a strategy for global competitiveness. In addition, trade preferences are eroding, and aid flows for the Caribbean declining (from an average 6 percent of GDP over 1990-97 to around 3 percent over 1998-2002). And one of the key drivers of growth in the past, the sun and sand based tourism industry, has seen a decline in growth and market share.

17. So it cannot be business-as-usual. Growth projections, using a cross-country regression framework, show that the median Caribbean country would, under a 'business-as-usual' scenario, see a per capita annual GDP growth of 2.2 percent over 2001-10, lower than the median growth rate of 2.8 percent over the previous four decades, and only marginally higher than the low growth of 1.8 percent in the 1990s (Annex Table 1.10). This scenario assumes that structural policy indicators progress at the same rate as in the previous decade.

18. A 'policy' scenario, where each country's structural policy variable is assumed to improve to the 75th percentile of its distribution in the Latin American and Caribbean region, increases the expected median per capita growth rate to 2.9 percent (Annex Table 1.11). Over half of the gains in average growth come from the reduction in government burden—government consumption to GDP being well above the regional standards—and this is one of the key themes explored in this report. Expected gains are larger for countries that are currently far behind the top regional standards, including Haiti, Suriname, and Guyana. Haiti gains from improvements in infrastructure and education, Suriname from opening up trade, reducing government consumption, increasing financial depth and improving education, and Guyana from improvements in infrastructure and reducing government consumption. The OECS countries with a particularly high government burden see major gains from improvements in this variable. Jamaica's projected 0.8 percent annual per capita growth for 2001-10 is the lowest for all countries, most of it arising from a reduction in government consumption, and reflects both the low growth of the past as well as its already high achievements on most of the policy variables.

19. Of course, achieving results under the policy scenario would not be easy, and, for countries such as Jamaica, St. Lucia, St. Kitts and Nevis, Trinidad and Tobago, and Dominica, would demand going beyond the standards demanded by the 75th percentile, and also addressing

other factors not taken into account in the framework of the above projections (such as crime for Jamaica, educational quality for all, and improving the investment climate in general).

20. Actions under the policy scenario and beyond would be necessary to improve productivity and diversify, which are the only paths to sustainable improvement in growth. The decline in productivity has been documented earlier, and would need to be reversed if growth rates are to improve. Moreover, new areas for efficient and profitable investment would also be required, given the declining productivity in existing activities, and would require, among other things, improvement in the investment climate. The examples of small countries such as Singapore, Cyprus and Ireland show that it is possible to successfully diversify and move up the production chain to higher value-added products. Indeed, this is happening already to an extent in the Caribbean. Offshore education and ICT-enabled activities are areas of potential growth, particularly for English speaking countries. Barbados and, to a lesser extent, Antigua and Barbuda, have gained from offshore business. The Dominican Republic and Trinidad and Tobago have seen some increase in manufacturing activities. Belize has increased exports of shrimps. And many countries are trying to diversify their tourism products, beyond sun-sand-sea related services.

21. This report takes the results from the cross-country growth analysis as a starting point, and then goes beyond this to analyze in detail some of the key factors that could enable productivity improvement and diversification. These include an assessment of government finances and the role of government, the investment climate, the labor market, education and skills, and infrastructure.

Improving government finances and expenditure

22. With Independence in the 1960s, most Caribbean countries sought to play a catalytic role in economic development, which, combined with the dominant development thinking of the times, led to an expanded and interventionist role for Government. Several decades and many problems later, the same Governments began, in the 1990s, to shift to a private sector-led, market-based development strategy, and to reform their public sectors.

23. However, these intentions were not reflected in outcomes, with government expenditures, as well as taxes and debt, actually rising significantly since the first half of the 1990s. Government spending rose for every country for which there is data, and the average rose from 27 percent of GDP over 1990-97 to 32 percent of GDP over 1998-2003, often in an attempt to use expansionary fiscal policy to address exogenous shocks (Table 1). The increased spending owed to rising wage bills (increase in employment, often accompanied by real wage increases), rising capital spending, especially in most of the OECS countries, and rising interest costs. Revenues rose, but not by as much, and average fiscal deficits in 1998-2003 are about 3 percentage points of GDP worse than in 1990-97.

Table 1: Caribbean: Government Expenditures, Revenues, Deficits and Debt

	Government Expenditures (% of GDP)		Government Revenues (% of GDP)		Overall Fiscal Balance (% of GDP)		Total Public Debt (% of GDP)	
	1990-97	1998-03	1990-97	1998-03	1990-97	1998-03	1997	2003
Antigua and Barbuda	n.a.	29	n.a.	21	-5	-8	102	142
Bahamas, The	n.a.	n.a.	n.a.	n.a.	-2	-2	46	48
Barbados	27	37	24	32	-3	-5	62	84
Belize	n.a.	32	n.a.	21	-6	-11	41	100
Dominica	35	41	32	32	-3	-8	61	122
Dominican Republic	16	18	14	15	-3	-3	23	56
Grenada	31	37	28	30	-4	-7	42	113
Guyana	38	44	34	38	-4	-6	211	179
Haiti	9	10	5	7	-4	-4	n.a.	44
Jamaica	28	35	28	27	0	-9	103	142
St. Kitts and Nevis	30	43	28	32	-2	-11	86	171
St. Lucia	27	29	26	26	-1	-3	36	69
St. Vincent and the Grenadines	31	33	30	29	-1	-4	48	73
Suriname		36		30	-4	-6	24	44
Trinidad and Tobago	28	26	28	24	0	-2	52	54
Caribbean Average	**27***	**32***	**25***	**27***	**-3**	**-6**	**67**	**96**

Source: IMF

* 11 country average

Note: Differences between fiscal balance and revenues minus expenditures reflect rounding.

24. These developments, along with assumption of government-guaranteed public and private enterprise debt, and the resolution of financial crises, have generated a surge in public debt in the Caribbean and this can have a major dampening effect on a private sector-led growth strategy (see Growth section above). Average Caribbean debt in 2003 was 96 percent of GDP,[2] compared with 65 percent of GDP in the six Central American countries.

25. Once high government debt sets in, it is not easy to reduce, since it is self-reinforcing, on account of the high interest costs. Debt restructuring is one option, but this is an unattractive policy, if not prohibited, in Caribbean countries. The other option is the Jamaica strategy of high primary surpluses. However, despite Jamaica's very high surpluses, its debt has increased in recent years, as a result of takeovers of contingent liabilities, spending related to natural disasters, and fiscal slippages before elections. Nevertheless, increasing primary surpluses, i.e., containing non-interest expenditure and maximizing revenues, is the only permanent solution to the Caribbean debt problem, since a debt problem can easily recur even after a restructuring, as has happened in some HIPC countries. Several Caribbean countries have recently gone this route of improving primary balances surpluses, but need to sustain this over a long period.

26. Tax revenues are already significant in most countries. While reducing tax incentives, improving tax administration and taxing the large informal sectors do present some possibilities for revenue gains, these gains are by and large unlikely to be significant in most countries. And attempts to increase primary surpluses by tax rate increases could be counter-productive in the Caribbean, except in the Dominican Republic, Haiti, Antigua and Barbuda and Belize. In other countries, since tax revenues already represent a significant fraction of GDP, higher tax rates might deter growth.

[2] Simple Average.

27. Thus, reducing government expenditure and improving its efficiency is the key to improving the primary surplus, and hence to a sustainable and stable fiscal situation in the Caribbean. In this context, an examination of the key components of government expenditure can be fruitful.

28. Caribbean governments' education expenditures are high, an average of almost 5 percent of GDP over 1995-2002, compared with 4 percent for Latin America and the Caribbean, reflecting high per capita incomes, as well as high average governance indices for voice and accountability in the English speaking Caribbean. Also, in most English speaking countries, teachers represent a powerful voting bloc, which helps to push up their salaries and hence government expenditure. While there may be some scale economies of classroom size, this appears to be offset by higher non-teaching costs. Reducing education costs without compromising on quality appears to have more certain payoffs in controlling of teacher salaries, reducing subsidies on tertiary education, and greater reliance on private education (such as the Jamaica voucher scheme). Another possibility of reducing Government net costs is to attract more overseas students for education and training, which would help in spreading fixed costs of expensive laboratory equipment and opening up possibilities of greater specialization in disciplines, as is happening in the case of offshore medical education in Grenada and Dominica (see Chapter 5).

29. Health expenditures, by contrast, are relatively low, averaging 3.2 percent of GDP over 1995-2002 versus 3.6 percent for Latin America and the Caribbean, and 3.7 percent of GDP for Central America. There does not seem to be a satisfactory explanation for the lower expenditure on health, versus that for education; private spending on health also appears relatively low. One way to reduce health costs is to leverage each doctor with a number of interns, and substitute clinics for relatively expensive doctors and hospital care where feasible, but this has been unsuccessful in the region, partly because of the building of hospitals and the development of a "hospital" mentality in patients. In terms of reducing net costs further, the most promising avenue appears to lie in exploiting the possibility of health tourism. While this has already begun, it can be deepened much more, and if done successfully, will enable economies of scale in health education and health provision, and thus have significant positive externalities for the local populations. Within the Caribbean, economies of scale are already being exploited to an extent, such as in the cross-border movements of patients, and in the Eastern Caribbean Pharmaceutical Procurement Services' bulk buying of drugs, which seems to have reduced costs significantly. Additionally, it may be possible to have regional specialization in the provision of other health services such as lab testing. A common health insurance program across the Caribbean, with competition in service provision, could help to create market-based solutions to issues of scale (with the private sector cooperating and competing as necessary) and to reduce overall health costs.

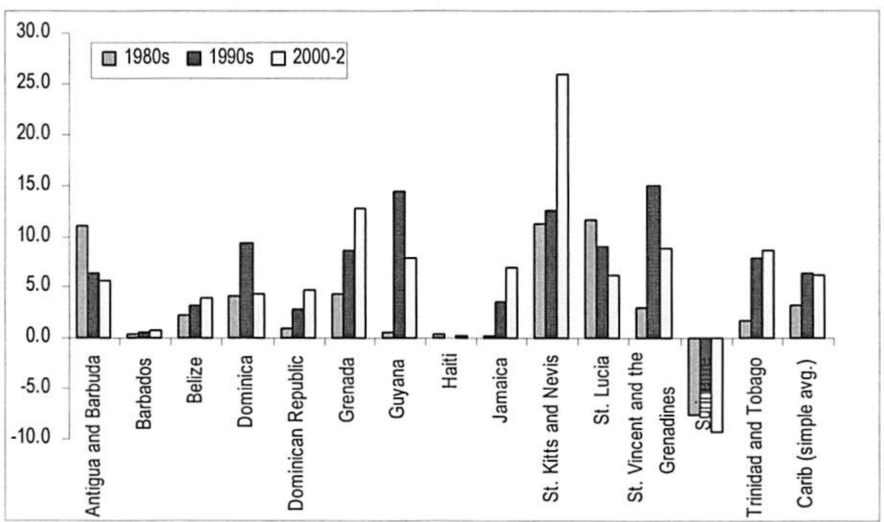
30. Government capital expenditures have varied significantly over time (in Grenada, for example, from 6.5 percent to 20 percent of GDP in 1995 and 2002) and across countries (from 1.8 percent of GDP for Trinidad and Tobago to 12.2 percent of GDP for Guyana over 1995-2002). This variation reflects lumpiness of public investment projects, attempts at counter-cyclicality, fiscal stabilization programs, and reconstruction costs after natural disasters, but also issues of data comparability across countries. Lumpiness appears to be a particular issue in the smaller countries of the Caribbean, where some countries appear to have 'invested their way into debt'—so requiring even more than usual care and scrutiny in capital expenditure. In other countries like Jamaica, fiscal stabilization has pared capital expenditure significantly, to the point where it may have begun to have a negative impact on growth. However, Jamaica, like most other countries, does not balk at guaranteeing private or public enterprise debt and incomplete or unsuccessful privatizations have resulted in the frequent takeover of contingent liabilities, the latest example being the re-takeover of Air Jamaica by the Government in December 2004. While privatization in small countries has been particularly challenging, countries should seek to learn from recent experience and avoid past mistakes, failing which pressure for such takeovers will persist, and public sector debt continue to grow.

Improving the Investment Climate to enable Efficient Private Sector led Growth is Critical

31. It is well appreciated that efficient and well-directed private investment is the key to sustained growth. The Government provides the 'investment climate' that shapes the returns and risks associated with investment. A good investment climate will include political and macro stability, a sound regulatory framework and efficient supporting institutions, and an adequate physical and social infrastructure.

32. In the Caribbean, overall investment rates have been quite high at about 30 percent of GDP since 1990, with private investment at about 20 percent of GDP including FDI at about 6 percent of GDP. In relation to the size of their economies, OECS countries have attracted significant FDI, especially St. Kitts and Nevis, Grenada, and St. Vincent and the Grenadines (Figure 4), as well as Guyana. Dollar inflows have been high in the largest economies of Jamaica, the Dominican Republic and Trinidad and Tobago. In terms of distribution, FDI has been concentrated in a few natural resource-related sectors, especially tourism, mineral extraction and segments within agriculture, indicating that as of now, the Caribbean possesses only a few competitive sectors. Investment in the Caribbean has been associated with reasonable but declining growth rates, which would point to declining productivity, which is indeed the case.

Figure 4: FDI to GDP Ratios in the Caribbean, 1980-2002



Source: International Finance Statistics, IMF.

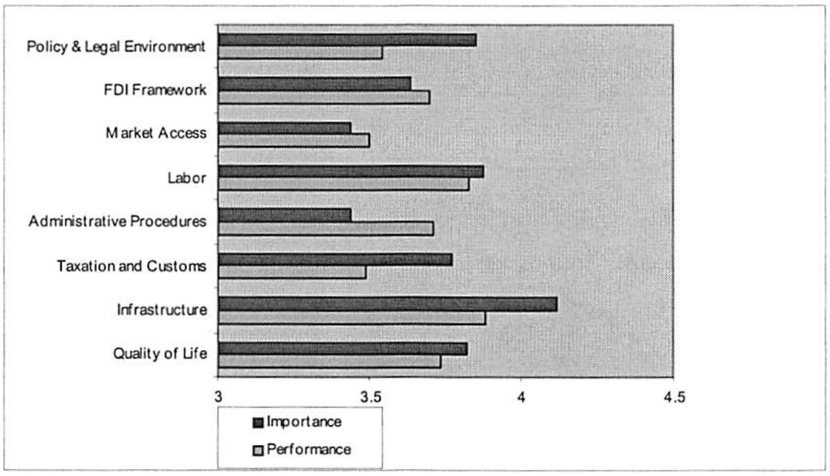
33. The future holds out more challenges, as indicated above. With preferences eroding, traditional industries such as tourism reaching a mature phase, and the environment in general becoming more competitive, private returns to investment will decline, with corresponding reduction in the incentive to invest. Moreover, even though the Caribbean still attracts a disproportionate share of world FDI, this share has been falling since the 1990s (its FDI to GDP ratio was 3.7 times the world average over 1990-94, but had fallen to 1.9 times over 2000-02). FDI in the Caribbean may be subjected to even greater pressure given the global decline in FDI and increased global competition for investment.

34. The challenge will thus be to maintain private investment rates and even increase them as in East Asia, for example in Singapore and Hong Kong in their high growth phase, and to make this investment more productive. In addition, falling productivity in traditional areas of investment will require investment diversification. It is important, therefore, that the investment climate improve in order to respond to these challenges, giving the right signals, encouraging productivity improvement and some investment in non-traditional areas including business and professional services, niche manufacturing and new segments in tourism.

35. A 2004 World Bank survey of 159 firms shows that foreign investors in the Caribbean perceive most components of the investment climate as very important to their investment

decisions, but pay particular attention to infrastructure, labor and the policy and legal environment (Figure 5). The survey also indicates that the performance ratings under infrastructure, policy and legal environment, and taxation and customs, in particular, do not meet the investors' expectations. Within each category, there are some sub-components which are of critical or major importance to firms. Some of these factors include political/regime stability, exchange rate stability, laws and regulations, attitude towards FDI, labor productivity, cost and availability of skilled labor, tax rates, telecommunications, power supply, shipping and ports.

Figure 5: Ratings of the Investment Climate in the Caribbean



Note: Importance rating scale: 3 = moderate importance, 4 = major importance, 5 = critical importance; Performance rating scale: 3 = neutral, 4 = good, 5 = excellent

36. Firms in different businesses, however, attach varying degrees of importance to the various factors affecting investment climate (Annex Table 3.1). As manufacturing firms tend to be more export-oriented, they are concerned about exchange rate stability and shipping services and ports, but less about access to land or anti-monopoly practices. Services sector firms, on the other hand, because they are more geared towards the local market, tend to focus on political and regime stability and local market size, but less on the availability of unskilled labor.

37. The survey also identified country-specific issues on perceived performance of the investment climate categories, for five Caribbean countries. Barbados is considered strong on the policy and legal environment, the FDI framework, and reliable utilities, but, with its high tax rates and weak tax administration, relatively poor on taxation and customs. The Dominican Republic is perceived positively on account of its low cost and readily available pool of skilled and unskilled labor, advanced telecommunications, good and widespread shipping facilities, but negatively for its unreliable electricity supply and exchange rate instability. Grenada is perceived positively on account of the availability of unskilled labor, and a good power supply, but negatively on availability of technical and managerial skills, high tax rates and import tariffs, and complicated customs clearance procedures. Jamaica's perceived strengths include telecommunications, a network of airports and seaports, access to skilled and unskilled labor, and weaknesses include low labor productivity, and high costs of crime. Trinidad and Tobago enjoys macroeconomic stability and abundant power supply, but suffers from high crime (especially targeted to business) and anti-competitive practices arising from a still significant public enterprise sector.

38. In order to help improve productivity and encourage diversification, specific aspects of the investment climate need to be strengthened, many of which are analyzed in the report in detail. Some of the important policy initiatives could include addressing the identified constraints including high corporate income tax rates, inefficient customs clearances, shortages of skills in some countries (an increasingly important issue for a knowledge-based production structure), low labor productivity, and some aspects of infrastructure.

39. The added challenge for the Caribbean countries is dealing with the issue of small market size, which has only been partially overcome by the very open nature of these economies. Accelerating trade integration in the CSME will help to increase 'domestic' market size, and moving as quickly as possible towards free movement of labor within the region will ease labor and skills shortages. Single visa and work permits for foreign nationals valid in all Caribbean countries will improve incentives for multi-country investment. Joint promotion by a regional investment promotion center to engage in image-building, provide information and aim to standardize procedures across the region could help attract investment.

40. The focus needs to shift from a subsidy-driven policy to one that provides a conducive investment climate for all potential investors. In this context, the region should seek to reduce and eliminate the damaging tax competition between countries that currently prevails, by implementing tax harmonization. In any case, the scope for tax incentives would be constrained by prospective revenue losses arising from possible future tariff liberalization.

The International Environment presents Challenges as well as Opportunities

41. Adjusting to the changing international trading environment is perhaps the most fundamental immediate challenge for the Caribbean. Trade preferences are being eroded, tariff revenues are facing the prospect of decline, and, perhaps most damning of all, competitiveness is declining. Reversing the decline in competitiveness will not be easy, and will require tackling, among other things, and in varying degrees in different countries, the fiscal deterioration and associated instability, high and often rising wages, and inadequate skill formation and technology absorption. At the same time, there are also some increasing opportunities, especially in services, which the Caribbean could exploit if some of the above challenges are addressed and the investment climate improved.

42. While remaining very open, trade to GDP in the Caribbean has declined from an average of 135 percent to 118 percent of GDP over 1990-2001, with Trinidad and Tobago, Grenada, Haiti and Belize being exceptions to this trend. Much of the reason for this could be traced to the real appreciation in the currencies over the 1990s, which leads to lower valuation of imports and exports relative to GDP. Trade patterns have changed somewhat since 1990. Merchandise exports fell from 52 to 45 percent of total exports of goods and services between 1990 and 2001, while services rose correspondingly. Owing to CARICOM trade preferences, intra-regional exports rose from 13 to 20 percent of total exports over the decade of the 1990s.

43. Several indicators suggest that there has been a decline in competitiveness of the Caribbean countries since 1990, particularly in goods trade and in the CARICOM group. CARICOM's market share in merchandise imports of NAFTA fell from 0.71 percent in 1985 to 0.27 percent in 2000, and EU market share fell as well. Even in tourism, the most dynamic export segment, CARICOM's market share in share of international tourist arrivals declined from 0.91 percent in 1990 to 0.69 percent in 2002. The Hispanic Caribbean, the Dominican Republic and Cuba, gained in tourism, partly at CARICOM's expense. Compared to the 1980s, export growth rates of services as well as goods declined over 1991-2002. The current account deteriorated alarmingly for most countries except for the oil producing Trinidad and Tobago over the period, partly a reflection of the increased fiscal imbalances as well as the appreciation of real exchange rates. In fact, for nearly all countries, the REER appreciated in the 1990s. It started to reverse in 2002, and had reached 1990 levels for most countries by 2003, excepting Jamaica, Haiti and Suriname. The appreciation in the currencies can be traced to the large capital inflows on account of fiscal imbalances and the need to borrow (reflected in the significant increase in debt), rising remittances, continued high FDI to GDP ratios, all of which more than covered the rising current account deficits. Earlier, in the first half of the 1990s, when the fiscal deficits were much lower, the average REER did not appreciate.

Table 2: Key Trade Related Indicators (percent of GDP)[1]

	1990	1995	2000	2002[2]
Trade Openness	135.2	131.6	121.5	117.7

Current Account	-6.4	-5.4	-9.5	-13.0
FDI (simple average)	4.8	6.1	5.8	5.8
FDI (weighted average)	1.9	3.6	5.0	4.8
Total exports (GNFS)	62.1	61.8	54.9	52.1
Merchandise Exports	34.1	31.3	25.6	24.1
Tourism Receipts	22.2	21.0	19.3	17.9

Trade openness: exports plus imports of goods and services expressed as a percentage of nominal GDP at market prices.

[1] Simple averages for the 15 Caribbean countries.

[2] 2002 or latest year available.

Source: WDI and WTO database.

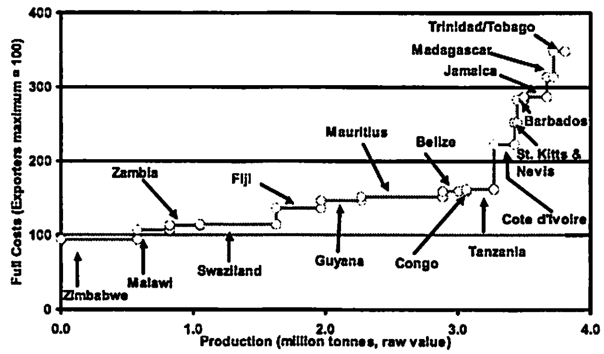
44. Potential tariff liberalization can have an impact on both revenue as well as production in some countries/products. While average protection levels for domestic production under CARICOM's Common External Tariff are not high, ranging from 7-13 percent, peak tariffs vary from 40-400 percent. Exemptions allow tariffs outside the CET range, and some countries also use taxes and surcharges on imports to bolster revenue/protection, rendering actual tariffs across countries quite variable. With import duties on average forming about 15 percent of tax revenue in the Caribbean, calculations show that under an FTAA led liberalization, the average loss of tax revenue would be about 11 percent (2.4 percent of GDP). The Bahamas and most OECS countries would be affected significantly, and this would exacerbate the fiscal problems of St. Kitts and Nevis, Grenada and Dominica, as well as Jamaica and the Dominican Republic. It would also reduce the scope for fiscally-led industrial policy, used extensively by most if not all Caribbean countries. In terms of reduced protection and the resultant impact on domestic production, the hardest hit are likely to be high duty products such as food and live animals, beverages and tobacco, and some manufactures. Anecdotal evidence suggests that non-CARICOM products that are very popular despite high duties on such products include beer.

45. Empirical evidence shows that trade preferences enjoyed by the Caribbean may represent a missed opportunity rather than a blessing. Preferences affect the pattern of trade but not the overall volume of trade, and in fact one study shows that over 1976-2000, countries that were dropped from the GSP, a major US preferential program, performed better than those still in the program. In general, trade preferences have not delivered because they have diverted investment and limited resources and entrepreneurship into sectors that are not necessarily ultimately competitive; reduced the pace of trade liberalization in the recipient countries owing to their being left out of the reciprocity-based system; and limited benefits owing to complicated rules of origin and unpredictability of preferences. Thus, Caribbean services exports, which are not dependent on unilateral trade preferences, have grown at 7.6 percent over 1981-2002, much faster than the 2.8 percent growth of goods exports, much of which have enjoyed preferences. Jamaica's apparel industry, fostered by preferences and quotas under the US Caribbean Basin Initiative, lost out once its relative preferences were eroded with the onset of NAFTA and the growth of textile production in the Dominican Republic, having had low incentives to improve as long as it was growing under preferences. It also suffers from fundamental problems related to crime and violence and its associated costs. Overall, even if the arguments against preferences are ignored, there can be no doubting that the Caribbean has not been able to use the preferences to its advantage, and has not performed well under the various preferential regimes under which it operates.

46. Even more than apparel, sugar and bananas have received generous preferences in the past, but do not even fill existing quotas and now confront declining preferences and unemployment in the sectors, a process that has already begun. Most Caribbean producers of the two products would not be in existence without preferences. Sugar exports and production in the Caribbean have declined by about half since 1970 owing to rising costs of production, resulting from rising wages, deteriorating field and factory performance and increasing inefficiencies associated with public sector control and management. Estimated costs of producing and

exporting sugar in Guyana and Belize, the lowest cost producers in the Caribbean, are 50 to 60 percent higher than one of the higher cost free market exporters (Figure 6). World sugar production costs have fallen by about 40 percent in real terms since 1980, while those in the Caribbean have been rising, and preferential quota prices have also been falling. With pressure on the EU and the US for reform of their sugar programs, preferential quota prices are expected to fall further, pressuring uncompetitive Caribbean producers.

Figure 6: Raw Sugar production costs of ACP producers
Average of 2000-2002



47. Similarly, in bananas, the Caribbean countries are amongst the highest cost producers in the world, rooted in low land productivity, and high labor and transportation costs. Land yields in Belize are comparable to those in Ecuador, but St. Lucia, Jamaica and Dominica have yields that are 20-35 percent of Ecuador's. Only Belize surpassed its quota allocation prior to 1999, and preference erosion thereafter has seen falling production in all countries except Belize and the Dominican Republic. In 2006, the current tariff-quota system will be replaced by a tariff only system. A DFID sponsored study projects that with a tariff of Euro 75/ton, the current in-quota tariff rate, only Belize would be able to export profitably, while St. Lucia, St. Vincent and the Grenadines and Dominica would incur losses at levels below Euros 150, 175 and 200, respectively. Even if the tariff is set around 200 Euros, most Caribbean producers would survive at very low profit margins, while Latin American producers would reap windfall profits and possibly increase their comparative advantage.

48. Regional integration has been a major plank of Caribbean policy, as exemplified in the 1989 amendment establishing the CARICOM Single Market and Economy. While commitments on CSME are extensive, implementation has lagged. The commitment to free trade in the region has made progress, but exceptions still remain, including quotas as well as allowed tariffs on some agricultural and other products. Some progress has been made on trade in labor services, to allow free movement for graduates, media workers, musicians, artists and sportspersons. Jamaica, Trinidad and Tobago and Barbados have ratified early implementation of some aspects of CSME, starting January 1, 2005, including extending free movement of labor to architects and engineers. The full CSME is scheduled to come on stream in 2008, with the eventual goal of complete dismantling of restrictions on labor movement within CARICOM.

49. This report suggests a recognition that preferences will not survive in the medium-term, and hence urges a pro-active vision for preference reduction, a phased decline in the external tariffs to reduce trade diversion, and use of the FTAA as a stepping stone to multilateral liberalization:

a) Unilateral preferences: Given the unclear long-term effects of unilateral preferences, and the fact that preferences will eventually not exist, the region could pre-empt the future erosion of preferences by negotiating an orderly dismantling of preferences in return for enhanced technical and financial assistance. This would be the Caribbean's pro-active trade agenda, and its own version of a new type of special and differential treatment.

b) CSME: Integration within CARICOM suffers from possibly large trade diversion, owing to still relatively high external tariffs on many products. To improve benefits from CSME's trade agenda, the Common External Tariff (CET) could be lowered further, towards the goal of low and uniform duties, and remaining quantitative restrictions be removed. Other aspects of CSME could impart economies of scale and should be pursued with vigor, especially labor, investment promotion, and training.

c) FTAA or EPA: As above, favorable market access i.e. preferences, is likely to lead to only transient gains (in any case more likely in services, since goods trade already enjoys significant preferences), and there are likely trade diversion costs of granting favorable access, in this case possibly excluding competitive producers from Asia. However, since the CSME already exists, and diverts trade, the FTAA or EPA producers will compete with and substitute some less efficient CSME producers, which would mean net trade creation. To the extent that the CET is reduced (unilaterally or multilaterally), the remaining trade diversion may be reduced further. The latter action would of course mean further erosion of customs revenue, which will require remedial action.

d) WTO: The logic of the above means that in the longer-term, the most abiding gains for the Caribbean are likely to come from reduction of its external tariffs. Under multilateral liberalization, i.e., under the WTO, this could also mean some enhanced market access for all countries. It is important, of course, to recognize that the Caribbean's small size reduces the scope for reciprocity-based negotiations. In these conditions, domestic reforms should not be allowed to depend on successful international negotiations. In any case, the unilateral reduction of tariffs would help to reduce the costs of trade diversion that may result from the conclusion of regional preferential arrangements.

50. Policy options in other trade-related areas include the need to address revenue losses stemming from prospective tariff liberalization by taking action to set in place VAT or other domestic tax systems, and also reducing incentive-based industrial policy. The likely impact of this reduced protection on domestic agriculture and manufacturing will need to be handled by strengthening social protection, training, and improving the investment climate to encourage investment and redeployment. The sugar industry could be privatized or closed down, or general enabling conditions established that encourage diversification out of sugar into fresh fruits, vegetables, meat or dairy products, as has been done in Jamaica to some extent. In manufacturing such as apparel in the Dominican Republic, some high-value products could survive the dismantling of the MFA, especially where timeliness and hence location is important. Here, improving logistics and customs procedures, factors also identified as obstacles in investor perception surveys, will help impart an edge. Improvements in the investment climate to encourage diversification (such as better quality of education and training) will help new (niche) exporting sectors to emerge. Accelerated implementation of the CSME, especially in those aspects related to trade, labor, FDI, capital mobility and regional standards will make the Caribbean a more attractive investment destination. Improved market access in trade negotiations should seek to focus on services, especially on easing of restrictions on temporary movement of labor, such as has occurred between the Caribbean and Canada. Bilateral agreements on temporary migration offer an alternative means to realize the gains from labor mobility without suffering either the costs of brain drain or foreign hostility to permanent migration. Finally, trade negotiations are likely to be more successful if the region speaks up with one voice, and the Regional Negotiating Machinery should be empowered to negotiate on behalf of CARICOM at all regional and multilateral forums. For many of the above issues, the region may need significant time for transition, but it would be useful if, as in the MFA, it agrees to a time-bound program for phase-out of preferences and duty reduction.

Emerging Opportunities, especially in Services

51. While there are several areas of manufacturing and agriculture in the Caribbean that are not competitive and will find it hard to compete in a more open market regime, small economies can be competitive in many services sectors and, indeed, in niche manufacturing. The examples of Ireland and Singapore present dramatic illustrations of the possibilities. This report explores illustrative case studies of ICT-enabled products and services, higher-end tourism, offshore education, and health services. As the case studies demonstrate, success in moving to higher-end

services (which is where the possibilities lie, given that high wages rule out competitiveness in lower-end areas such as call centers and tele-marketing) requires high skill levels, and underscores the emphasis in the report on improving the quality and cost effectiveness of human resources. Given the potential of the services sector, Caribbean governments could consider investors' priorities as a way to prioritize their own policy actions to improve the investment climate. It is worth pointing out that this is different from picking winners, since it only creates an enabling environment that may allow investment in certain services sectors in the Caribbean. For example, telecommunications is usually a top priority if a country sees potential in ICT-enabled services and in medical services (see Annex Table 3.1), and would point to the need to bring telecom facilities up to the requisite cost and quality standards. This would, of course, help all business, since telecom is a key aspect of infrastructure.

52. The effective use of ICT is an essential ingredient for attaining competitiveness in both services and niche manufacturing sectors in the Caribbean. Amongst Caribbean services exporters, there are many examples of firms that have utilized ICT to cut costs, improve communications with customers, improve logistics, overcome distance and understand their competitive positioning. Unique Jamaica, a cluster of 100 small hoteliers and attractions, used ICT to launch a cost effective marketing campaign devised to attract higher-end adventure/nature tourists. SM Jaleel – a soft drink company in Trinidad and Tobago– identified an untapped market among children and has built a global brand, "Chubby", now sold in major US retailers. In order to foster an environment for greater and more effective use of ICT, Caribbean policymakers would need to facilitate access and create a more competitive telecommunications sector (including addressing the problem of high internet costs), upgrade human resources, provide support services for firms, and accelerate regional harmonization in key policy areas related to ICT.

53. Growth in tourism has slowed over the last decade, owing to the maturing of the region's sun, sea and sand product. However, growing demand in new product areas such as adventure and cultural tourism provides an opportunity for the region to revitalize the tourism sector and move into areas that could deepen linkages with the rest of the economy. Already, there are several success stories in these new niches, including St. Lucia's Jazz Festival, Dominica's Creole Festival, and Barbados' upscale resort Sandy Lane. Success in these new areas requires that Caribbean governments improve the investment climate (including addressing the issue of crime in some countries) by managing and marketing the sector more effectively (with a key role for a regional investment promotion strategy), improving destination and product quality, and addressing skill deficiencies. Careful management of the environment is, of course, paramount to achieving and maintaining competitiveness in both new and old product areas. Governments must carefully steward the region's resources to mitigate environmental damage and risk while not compromising environmental standards to attract investment.

54. Offshore education, and, in particular, medical schools, represent a small but growing services sector that has responded to a growing (and unfulfilled) demand for physicians in the United States. St. George's University School of Medicine in Grenada and Ross University School of Medicine in Dominica are two of 23 primarily offshore medical schools in the region, whose graduates together account for close to 70 percent of the international medical graduates entering the US. Demographic trends suggest continued demand for international physicians in the US, suggesting a significant opportunity for continued growth of this sector. To continue to meet this demand, and deepen the economic impact of the sector, the region should focus on creating a robust investment climate by raising accreditation standards, supporting regional accreditation agencies, and moving towards a harmonized and transparent investment regime, including encouraging FDI in the higher education sector.

55. Finally, growth in the delivery of cross-border provision of health services has created opportunities for Caribbean health service providers. There are many examples of successful health tourism providers in the Caribbean including health and wellness centers (such as Le Sport in St. Lucia) and rehabilitation services (such as Island Dialysis in Barbados), among others. Expansion of trade in health services will need to be largely private sector driven. To foster

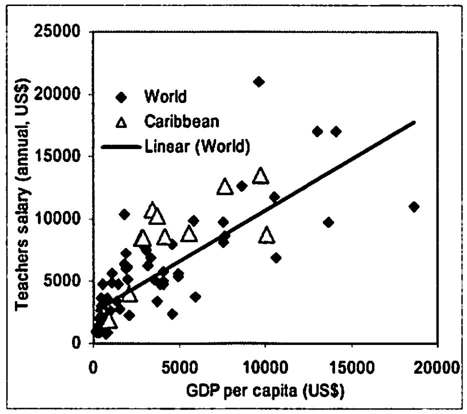
growth in health services, governments should harmonize regulations within the region, seek to improve variations or gaps in quality of health care, including through regional accreditation and licensing (the Caribbean Association of Medical Councils playing a lead role), address the issue of availability of skilled professionals, and increase the portability of health insurance. Also, creation of linkages between offshore medical education and provision of medical services could generate greater economies of scale and be mutually beneficial for both sectors.

Persistence of High Wages and non-Wage costs despite High Unemployment

56. Wages in many Caribbean countries are high, relative to their per capita incomes (see Figure 7), despite the existence of relatively high unemployment rates. Moreover, at least in some countries for which data is available (Barbados, Jamaica, Trinidad and Tobago), real wages grew slightly faster than labor productivity in the 1990s, meaning that real labor unit costs of production rose.

57. Wages are relatively high in the Caribbean, and have constrained competitiveness (see Figure 7). The reasons for this include the following. First, the combination of large and/or prominent public sectors along with positive public sector wage premiums in most countries (for example, 12 percent in St. Lucia, 27 percent in Barbados, to 37 percent in Trinidad and Tobago) influences the rest of the economy's wages and wage setting processes. In some cases, the government sets the tone for wage increases for the country as a whole by settling its negotiations ahead of private

Figure 7: Qualified Teacher Salary in State School (annual $)



Source: Commonwealth/UNCTAD Small States Business Cost Survey (2002).

enterprises. Second, many governments legislate either sectoral or national minimum wages, which can be quite high relative to average wages and which typically take account of price changes rather than poverty levels. Both these factors effectively reinforce inflation rather than tying wage increases to productivity gains. Third, high remittances as well as high migration to other countries within the Caribbean as well as outside increase the reservation wage.

58. Significant non-wage costs also distort the labor market and render it less competitive. While Caribbean countries show a lower index of labor market rigidity than those in Latin America, the large and in many cases growing informal sector shows that the enforcement may be more rigid. Also, even though declining in importance, unions are politically powerful, and can affect labor relations and wage-setting, which also creates incentives amongst employers to create informal employment. Moreover, despite some decline over the last decade, unemployment rates in most countries except the Dominican Republic and St. Kitts and Nevis tend to be high, which implies the existence of rigidities that prevent unemployment from falling to 'frictional' levels, and keep formal sector wages high.

59. Migration has been a key influence on the evolution of the labor market in the Caribbean. The education level of migrants to the US, UK and Canada tends to be high, much higher than the average in the country of origin, which means there is a loss of skills; opportunities for migration as well as remittances also increase the reservation wage. However, migration increases the demand for education in the sending country. To the extent that migrants return, migration also facilitates skill and human capital accumulation, and there is some migration for tertiary education itself. Remittances finance schooling and investment, as well as consumption of goods. And the Caribbean expatriate community makes significant non-financial contributions that increase Caribbean competitiveness, such as through technology and knowledge transfer, FDI and other financial flows, and market contacts (which helps niche trade development). Further, intra-Caribbean migration has helped to reduce shortages of both skilled as well as unskilled labor, with Trinidad and Tobago hosting over one-third of the intra-Caribbean migrant population (excluding the Dominican Republic). Haitian migration to the Dominican Republic has helped to keep its labor costs down and allows it to compete internationally in textiles and other labor intensive products. Thus, while the net welfare impact of Caribbean migration is difficult to assess, policy should seek to reduce the costs of the brain drain by increasing fees for higher education scholarships; improve linkages with and the flow of benefits from overseas residents; encourage further reduction in the cost of transferring remittances; better leverage remittances for investment purposes; and accelerate wage and skill arbitrage through faster implementation of the CSME.

60. Persistently high unemployment is a particular cause for concern. Employment growth slowed down in most countries in the 1990s, and was concurrent with the slowdown in output growth, and there is evidence for a few countries showing the elasticity of employment varying

between 0.22 and 1.1 during 1970-2001. High levels of open urban unemployment prevail in the larger countries while rural unemployment and underemployment exist in the OECS. Apart from weak aggregate demand arising from weak growth performance in the 1990s, high unemployment reflects the disconnect between education curricula and skills demanded in the private sector, exacerbated by the contraction in agriculture and manufacturing and the shift towards services. In addition, there are those who choose to remain unemployed, which happens when a household member receives remittances or for the time that people queue up for public sector jobs. The characteristics of the unemployed are similar across the region. The unemployed tend to be young, disproportionately female, and poorly educated. While lower than that of females, unemployment of young males is still very high, and is related to significant social problems such as crime and drug trafficking and addiction. Youth aged 15-24 account for 40-56 percent of the total unemployed pool. Unemployment tends to be low or non-existent among those with tertiary level education (except in the Dominican Republic), reflecting the scarcity of skilled labor.

61. Addressing the fundamental weaknesses in the labor market will help improve competitiveness, exports and aggregate demand, and also increase employment, a key factor in reducing poverty and improving the quality of life. Reform in public sector compensation policies, aligning them more closely with merit and productivity criteria, thereby reducing the public sector wage premium, will help reduce distortions in the labor market. In many countries, the increasing size of public employment—effectively a job creation program to offset the high wages that it has created—has crowded out private employers, and reorienting the public sector (see above) will also help private employers to get hold of skilled/productive employees. Moreover, while the rigidities of the labor market are not insurmountable, they create non-wage labor costs that reduce labor demand. Modernizing labor regulations to increase employers' flexibility will be beneficial to workers in the medium and long run and should also help to increase the share of formal employment. While intra-regional migration has helped to address some of the shortages of skilled and unskilled labor, efforts to achieve a single Caribbean labor market will help further improve the competitiveness of the region as a whole, and should be accelerated. To benefit fully from this process, countries in the region should plan to address skill shortages and skill upgrading issues on a regional basis—i.e., it should be an ex-ante process rather than an ex-post one that only allows people to work in other countries. (Jamaica, Barbados and Trinidad and Tobago have recently enacted legislation to expand labor market integration to include architects and engineers, see Section on Trade). In terms of migration of skilled labor to OECD countries, the region could explore the possibility of cost sharing for education/training with the recipient country. It could also push for more liberal treatment for temporary labor movement, which reduces the permanent loss of skills from the host country, and is likely to encounter less hostility from the receiving country.

Renewed Focus needed on Education and Skill Development

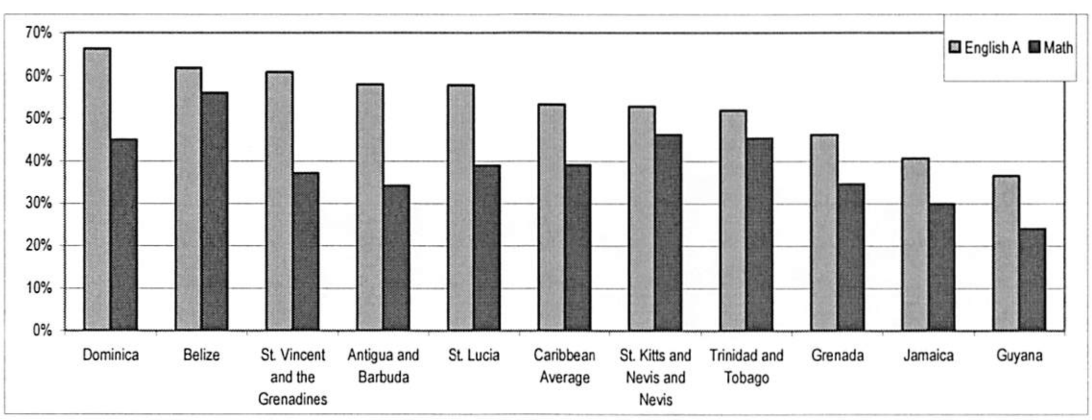
62. The skill endowments of the labor force are indispensable for learning, technology absorption, productivity improvement, diversification and overall competitiveness. However, this relationship is long-term, which is why the early Caribbean emphasis on education paid off for many decades thereafter—for example, as of 2000, enrollment in primary education was universal in all countries except Haiti, even though universal completion was yet to be achieved in five countries. With the recent weakening of the traditional sources of growth, and given that wages are high, companies need to move up the value chain and into niche market segments, making the need for a skilled labor force paramount. This is also attested to by the fact that investors have cited skill availability to be a critical factor in their investment decisions. However, concerns are now being raised regarding the quantity as well as quality of skills available in many countries in the Caribbean, which requires an urgent redress in order to improve long-term growth prospects. At the same time, the redress must deal with the migration of trained employees, else education and skill development by Caribbean countries will largely end up as a subsidy for industrial countries.

63. Many countries in the Caribbean have lost their initial momentum in the build-up of skills, which has serious implications for technology absorption and competitiveness. On

average, the adult population in six Caribbean countries (excluding the OECS) increased their average years of schooling (a proxy for the stock of skills in the labor force) from 4.8 years in 1980 to 6 years in 2000, with the Latin American average rose from 4.9 to 6.3 years, and the world average from 5.1 to 6.5 years. The Caribbean countries' average ranking declined from 47 out of 92 countries in 1970 and 1980, to 48 in 1990 and 52 in 2000. Figures for Barbados and Trinidad and Tobago are well above average, while those for the Dominican Republic and Haiti are below average. Given their slow growth rates in the average years of schooling in the adult population, it could take Jamaica 120 years and the Dominican Republic 154 years to catch up with the current level of the US. Similar indications are provided by data on secondary enrollment, wherein in 1980 the Caribbean average enrollment for 7 countries was 56 percent versus 42 percent for Latin America, but by 2000 the averages were 75 and 69 percent respectively. Based on earlier trends, these enrollment rates (and implicitly lower completion rates in the Caribbean) are expected to lead to further decline in the world education ranking of the sample of Caribbean countries. Partly, of course, the figures on stock of skills reflect not just the educational system in the Caribbean, but the migration of the most educated and skilled out of the country.

64. Of even greater concern than the quantity of skills is the quality of education. Educational quality affects both individual returns as well as the growth rate of the economy. A study based on 1990 US census data found that returns to education for migrants from Caribbean countries were 2.9 percent, versus an average of 4.8 percent for South American migrants and 4.9 percent for the world, indicating lower pay for the same job or lack of access to higher quality jobs on account of lower quality of education. At the school, the Caribbean Examination Council tests for secondary school students for English-speaking countries show a very low pass rate in most countries, 20-50 percent in mathematics and slightly higher for English (Figure 8). More glaring than the disparities across Caribbean countries are those within each country. Learning outcomes vary greatly between different schools in the same country, with the good schools attracting better coached, generally richer students. Girls perform much better than boys at exams and are less likely to drop out, and female completion rates in secondary education in 10 Caribbean countries are, on average, almost 30 percent better than male.

Figure 8: Low pass rates in Caribbean Examinations Council
Secondary examinations



65. Unlike at the school level, enrollment in tertiary education in the Caribbean has been historically low, and would appear to be an obstacle to achieving the goal of a knowledge driven economy. Average enrollment rates rose from 5 to about 15 percent over 1980-2000, but except for Barbados (41 percent) and the Dominican Republic (29 percent), remain well below the Latin American average of 24 percent or the world average of 26 percent. The low enrollment reflects low supply rather than demand, given that private returns to tertiary education are high. High returns make it more likely that individuals will be willing to pay higher fees and the private sector get more involved in the provision of tertiary education.

66. Job training aims to customize school learning to the specific technologies in use in the firm, making the firm the most appropriate unit of analysis for assessing training-related issues. In the Caribbean, 41 percent (Trinidad and Tobago) to 85 percent (Dominican Republic) of firms provide on-the-job training on a yearly basis, but the average of 65 percent is lower than the 75 percent for Latin America. More importantly, programs such as for youth and basic vocational training are not very well connected with the needs of productive enterprises. In the Caribbean, the Dominican Republic provides the best practice example, where 75 percent of training benefits employed workers, and most of it takes place within firms. To finance training, many Caribbean governments levy a payroll tax of around 1 percent, in line with international practice, but Jamaica's very high payroll tax of 3 percent does not deliver commensurate benefits. In terms of provision, there appears to be an over-reliance on state training institutes, where international experience has generally been disappointing. On the other hand, experiences in the Dominican Republic and in Mexico's Integral Quality and Modernization Program (providing cost-sharing for diagnostics and then training within the firm for small and medium enterprises) show that firm-based training achieves best results.

67. For success in a move towards increasing knowledge-based activity, Caribbean countries need to first endow all boys and girls with the basic skills and learning aptitudes arising from a quality primary and secondary education program. Reforms to achieve this goal have been spelled out in many documents, and include increasing accountability through decentralization of decision-making to the school level; enhancing collection and diffusion of educational information and basing policy on this; imposing benchmarks on teacher training to improve the intake of trained teachers; increasing the spread between starting and top-end salaries, to increase incentives. At the same time, reducing the very high share of salaries in the primary education system, by gradually reducing real starting salaries (see Figure 7), would improve funding for didactic material and improve the efficiency of the system. To expand secondary enrollment, governments should involve the private sector more than at present, for example with government vouchers as in Jamaica.

68. Similarly, given the fiscal situation, and given high returns to tertiary education, the concentration of such education in children of higher income families, and the large share of tertiary students who migrate, higher tuitions and increased private sector provision must play a much larger role in tertiary education, with well-designed student loan schemes and scholarships for the most needy. This could also involve public-private partnerships (as done by Grenada Community College). Both public and private provision of education needs to be more aligned with private sector needs (and higher fees do create more pressure for relevance), as has been done by the Barbados Community College. And government could demand greater transparency and accountability such as introducing performance contracts in their funding of tertiary education. In terms of training, the Caribbean countries could learn from successful training experiences, all pointing to greater involvement of firms in training decisions, and separation of the financing and supervision role from the provision role. Finally, Caribbean countries could build further on the momentum created by the Caribbean Association of National Training Agencies, including the mutual recognition of occupational standards, vocational and technical certificates, all with a view to eventually creating a genuinely integrated training, education and labor market.

69. Improving productivity and moving towards more knowledge-based activity also demand better technology adaptation, entrepreneurship and risk-taking. In the Caribbean, trade protection and preferences have led to an under-supply of entrepreneurship and therefore the search for new product areas. A phased reduction of such preferences, as discussed earlier, will also create more incentives for risk-taking and product diversification. However, the supply side of the equation also needs to be improved. Apart from high quality and relevant skills, investments in new product areas demands fostering linkages between universities and public research institutions and firms; implementing support for technology development through existing and incipient sectoral clusters; encouraging knowledge transfers from the diaspora and returning migrants; and providing a good investment climate, including one that encourages high quality FDI.