Administrative and Resource Implications for Small States[1]

Sir Neville Nicholls

Significant conceptual and technical issues have been raised on the appropriateness or otherwise of the OECD Initiative on Harmful Tax Competition. This paper considers administrative and resource implications from the point of view of the economic development and related fiscal management challenges facing small states, with a focus on those in the Caribbean region.

As has been demonstrated in the Commonwealth Secretariat-World Bank *Report on Small States* (2000) and in the consultations which were intended to guide the production of that report, there are a number of characteristics associated with small size which impose a range of restrictions on the kinds of traditional economic activities in which small countries can expect to become involved on a sustainable basis. The characteristics also affect the nature and functioning of the private and public sectors in the economies and, through effects on their individual capacities, influence their relative roles. Finally, the characteristics affect the extent and nature of the interaction between small economies, both jointly and separately, and the rest of the world.

In our small countries, these characteristics need to be placed in a context in which incomes are mostly low, infrastructure and services are relatively underdeveloped, the level and extent of educational attainment and skills are generally not broad and deep, and in which poverty continues to be a major issue. The situation is further complicated by increasingly strong demonstration effects of lifestyles in developed countries, with the social strains resulting from the mismatch between aspirations and the capacity to meet them manifesting themselves in a number of dysfunctional ways, some of which are quite serious. Not surprisingly, the major focus of governments and administrations in these countries is on economic development: to design, encourage and support activities which appear likely to contribute to sustained growth in incomes, both to facilitate private income growth in order to expand the potential for indi-

1 This paper is based on a speech given by Sir Neville Nicholls as President of the Caribbean Development Bank at the High Level Consultations on the OECD Harmful Tax Competitive Initiative, Barbados, 8–9 January 2001.

vidual freedom (to follow Amartya Sen's usage), and to enable public sector delivery of appropriate general social services, regulatory services, and targeted and other support services which are thought to be necessary for the attainment of the country's objectives and which are in accordance with accepted cultural practices.

Key development challenges these characteristics pose for many of our countries include:

✍A high degree of openness to trade in order to satisfy domestic consumption and investment requirements, given the nature of domestic production capacity, which reflects constraints on the range and volume of physical goods production as a result of limitations on natural resource endowments, including population, and consequential competitiveness issues related to scale economies;

✍Production flexibility issues in the private sector, related both to the physical goods capacity constraints identified above and to similar constraints on the human resources side. The two sets of constraints here compound the normal difficulty in switching products and product lines in response to changes in market demand induced by changes in tastes, competitiveness, and in production and consumption technologies. A related issue here is the extent to which, in many of our countries, the term 'private sector' means the same thing as it does in large economies, both in an objective sense, and subjectively from the point of view of the private sector itself;

✍Public sector capacity limitations, in both human and financial resources, which affect, on the domestic side, the provision of physical and institutional infrastructure to support private sector production, provide social services, and to maintain security and effective system regulation; and on the external side, the capacity to participate effectively in the ever-expanding range of international consultations and negotiations which have become a feature of modern times;

✍Constraints on the capacity for the development of broad, deep and competitive market structures, with consequential implications for the development of attitudes, practices and systems associated with competitive market conditions, for the nature of approaches to, and the effectiveness of, regulation, and for the nature of state intervention in the economy.

These characteristics have given rise to a number of behavioural practices which have had all sorts of consequences for the functioning of our economies. Firstly, the high degree of openness coupled with the narrow range of product items have contributed to considerable market concentration in our trading patterns. The specific markets of concentration have tended to reflect historical circumstances, with the situation being further complicated by a practice of providing external assistance via export price subsidies. This has had the effect of further limiting production flexibility.

Secondly, partly for historical reasons, domestic production linkages are not nearly as developed as international ones, with domestic production remaining near the lower value-added end of the scale. This factor, together with the narrow range of product items, have historically had significant implications for the education and skills requirements of many Caribbean societies. It has only been with the post-war development of mining and tourism activities, and much more recently with broader services industry emergence and development, that some demand for a broader range of skills has led to increased focus on tertiary education domestically and on the attraction of skills from abroad. Nevertheless, domestic market demand for particular types of skills remains thin, and the number of persons whose movement results in a shift from excess supply to complete shortage remains very small in many of our countries. For those skills which are in demand in the developed countries, Caribbean countries have discovered that, notwithstanding immigration restrictions which might exist, domestic and external labour markets are fully integrated, with consequential Dutch disease effects emerging across the board.

Thirdly, private sector activity has in the past been focused on serving the export sector, and on import activities to meet the consumption and investment needs of the societies. The emergence of domestic production to meet domestic requirements (small-scale foodcrop farming aside) has been relatively recent, initially involving assembly-type operations under protected market conditions. The emergence of a growing entrepreneurial focus outside the traditional export areas appears to have reflected a perception of domestic and external opportunities facilitated by the growth of tourism and associated service activities. The effort, beginning in the 1950s, to develop a domestic manufacturing sector, with substantial support from governments and based on an import-substitution approach, has not been particularly successful, partly because the protection arrangements did not promote efficiency and partly because of the characteristics of the industries (producing mainly household durables and low-value consumption items) which attracted investors to the sector, although some operations continue. (As an aside I should like to express the view that the heavy involvement of the public sector in directly productive activity in the region, and the extent and nature of public sector support for private sector activity, is largely justifiable on the basis of the nature of the private sector which mirrored the historical evolution of the broader society.) Service activity development in the private sector has been considerably more successful, and more recent, with many of the operations being directly or indirectly associated with tourism.

Production flexibility, in the sense of the ability of economies in our region to change products and product lines in response to changes in market demand, and to identify new product opportunities and to take advantage of them, has been severely constrained both by physical area issues and by issues relating to population characteristics. On the natural resources side, small size has resulted in such a large proportion of domestic resources being allocated to the production of the traditional export goods that not many resources have been available for new activities, particularly during the pre-services industry period. In many cases, shifting to other activities would have required the closing of some existing operations, a circumstance which would be contemplated only in a *force majeure* situation, because of the income loss and social and economic dislocation which would result from such an approach in poor countries. This is in contrast to what normally obtains in large economies, where production shifts occur as new enterprises utilising new resources introduce new products alongside the old operations, displacing them over time, or as divisions within technologically and managerially progressive firms maintain their information and product contacts with the markets. In both cases, the income losses and economic dislocation is absorbed, at least in the first round, by institutions rather than by individuals, by a combination of public sector safety nets and by labour reallocation schemes within individual firms. Safety net arrangements in the English-speaking Caribbean are in many cases rudimentary.

The contribution that external assistance through subsidising export prices has made, and continues to make, to production inflexibility has been mentioned briefly above. This is despite the very real contribution to national income that the assistance provides. Even with the announced termination of the preferential marketing arrangements, shifting production has continued to prove a major challenge for some countries. The situation should be read as an example of production-switching difficulties arising from human and natural resource constraints.

On the human resources side, these societies have not developed in ways that would make them responsive to perceived economic opportunities in the manner that current conventional wisdom would expect of 'modern' economies. Private sector capacity has tended to have a stronger focus on trade rather than on enterprise, and for a long time (and even today in some of our countries) the private sector has tended not to see itself as a self-conscious entity. This situation has posed difficulties for attempts to develop a national consensus and approach to development. Unlike in large economies, such an approach is required if the process of development is not to take a very long time, or even perhaps if development is to take place at all.

Similarly, the public sector has developed with a 'regulatory and control' focus, rather than one that is supportive of individual and social development and facilitates a proactive, expansionary approach to economic activity. In many countries, the public sector has been slow in recognising and institutionalising the critical proactive role it needs to play in small societies where capacity is otherwise limited. There is, however, increasing recognition of this role across the region, even though there has been a parallel recognition of the financial and other constraints to its institutionalisation.

A fourth behavioural practice has been the reliance on trade-based taxes on the movement of goods, and to a lesser extent on income taxes, to finance public sector operations. With exports constituting a high proportion of GDP, and with consumption and investment needs met largely from imports, governments have found it convenient to raise revenue from border taxes on goods, and to supplement these collections with excise taxes on selected locally produced items (for example alcohol, tobacco and fuel). This has been a source of significant fiscal pressure, and a number of Caribbean countries have experienced major fiscal and balance of payments problems as a result of expenditure growth outstripping sustainable financing capacity. As incomes have risen over time, both personal and business income recipients at the higher end of the scale, as well as the self-employed, have refined their tax-planning activities to avoid paying in excess of their legal liabilities, with the result that middle-income employees have tended to account for a substantial share of income tax collection. With a rise in the domestic production of non-traded items, particularly in the area of services, and with services featuring much more heavily in trade, a number of countries have been shifting their tax system focus to a more transactions-based approach. Only a small number of countries in the region have significantly advanced their tax-system focus in this direction so far. This is partly because of the significant administrative burden involved, given public sector staffing levels and skills. The introduction process has required a considerable amount of consultation, persuasion and sensitivity in those countries where it has been successful. Significant issues remain to be addressed in many countries in the region. Among them are:

✍How to deal with the regressiveness of transactions-based systems in the context of significant poverty;

- ✍How to treat transfer pricing issues in intra-Group transactions;
- ✍How to encourage the appropriate degree of record-keeping and accounts verification in the business sector;
- ✍In the context of e-commerce, establishing and verifying liability where cross-border activities are increasingly commonplace.

A fifth aspect of small state behaviour is the extent to which they are affected by external shocks, whether these shocks result from natural disasters or from adverse external economic events. Caribbean countries have been badly affected by hurricanes during the last five years in particular, and those familiar with the small states in our region will readily appreciate that hurricane damage is almost always country-wide in scope. The pace of capital accumulation, especially in infrastructure development, has been slower than it might otherwise have been because of the ongoing need to repair and rehabilitate. The actual costs of construction are higher than would otherwise be the case because of the need to build strong structures. On the economic side, output product concentration results in significant exposure to adverse factors affecting one or two industries, given difficulties in diversification.

This vulnerability has led to significant income volatility, with consequent effects for private sector calculations of minimum acceptable returns to risk, and with similar effects for the ability of the public sector to plan future activities. To the extent that financial institutions adopt conservative lending strategies in this environment, such an approach contributes to an overall pattern which tends to slow the overall rate of investment and the expected rate of economic growth.

The situation is further complicated by developments in the free trade enterprise in which we are all now engaged. Under the current regime, we can expect fairly rapid declines in the allowable rates of tariffs on the movement of goods and services, and strong pressure for the effective removal of any remaining restrictions on the movement of capital, management, skilled labour and entrepreneurial talent. Falls in tariffs will subject Caribbean producers to levels of competitiveness with which many of them will not be able to cope, and many of them may go out of business. It is not clear how our societies and fiscal systems will cope with the increase in unemployment which will result, given our rudimentary safety net systems and the fact that nowhere in the globalisation process and negotiations has explicit attention been paid to its effects on labour in small countries. The present globalisation debate, as reflected in the statements coming from the developed countries and their agencies, does not refer to the movement of labour as part of the liberalisation process. This flies in the face of economic logic.

While people in Caribbean societies have always, like others around the world, sought to improve their living levels, the rate of expansion of their aspirations has grown tremendously as a result of the development of tourism as an important industry, and particularly with the more recent enhanced penetration of our region, and by the demonstration effects of developed country lifestyles resulting from the information and telecommunications revolution. Physical constraints associated with small size have prevented countries in the region from expanding the production of goods for export in a sustainable way, and they have accordingly been relying increasingly on service sector activity in their quest for sustained growth over the long term. Incentives for investment in real sector enterprises, as opposed to service sector enterprises, have not (with the exception of mining), yielded the expected results, largely because of the physical resources production constraints discussed above.

In these circumstances, Caribbean societies have had to make a realistic assessment of the economic opportunities open to them, and have sought, in full compliance with their international obligations, and in accordance with the advice and assistance provided to them by their bilateral and multilateral development partners, to encourage perfectly legal longer-term business activities in their jurisdictions. These activities are expected to contribute to the income growth which will help Caribbean citizens to achieve their development objectives with the same dignity and sense of self-reliance as other countries. Income growth is also required in order to finance the public sector activities necessary for the discharge of international obligations and maintenance of self-respect.

Attention needs to be drawn forcefully to the fact that all countries are not the same, and that they should not, therefore, be expected to behave in exactly the same ways. Differences in resource endowments, resource accessibility, patterns of utilisation and, critically, culture and outlook, will significantly influence behaviour and practice. The spirit of international co-operation and the principles of multilateralism and self-determination to which we all profess to subscribe, require that countries do not seek to impose their domestic cultural practices on others. Instead they should assist others to eliminate poverty and to enhance the personal development and personal freedom of all individuals in our world.