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Small Island States and a Free Trade Area of the Americas: Challenges and Opportunities

Summary: Trade liberalization and economic integration are powerful tools for reforming less competitive economies and improving conditions for private sector development and sustainable economic growth. As local markets are opened to foreign producers and investors, domestic consumers and producers alike benefit from access to a greater variety of lower cost and/or higher quality goods and services. Better consumer purchasing power, producer gains from lower cost inputs, new ideas and technology, and foreign direct investment, can result in more employment, faster economic growth and increased government revenue for poverty reduction efforts. Getting to this point, however, often requires policy reforms that are technically challenging to implement and politically difficult to sell to businesses and workers with a vested interest in the status quo.

For the Eastern Caribbean States, there are significant concerns about the impact of these reforms and the adjustment process on social cohesion and standards of living. However, as members of the WTO and the Caribbean Single Market and Economy, many of these reforms are already required as part of membership obligations. More importantly, there is widespread recognition within the OECS (Organization of Eastern Caribbean States) and elsewhere that these and other reforms are essential to the ability of Eastern Caribbean States to thrive as independent economies. In this paper, I argue that even accounting for the legitimate challenges of adjustment, the FTAA represents an unparalleled opportunity to balance the concerns of local businesses and workers with the benefits derived from improved market access, investment opportunities, trade-related technical assistance and capacity building. Through the FTAA, the Eastern Caribbean would have the opportunity to generate both the technical capacity, and the political capital, for confronting many of the difficult and contentious economic reforms that are so essential to their future well being.

My presentation will focus on the challenges of small island states in the rapidly evolving global markets where trading blocks and regional integration are becoming the norm. In order to illustrate these challenges in the context of the Americas, I will discuss the Organization of Eastern Caribbean States (OECS). After describing some of the characteristics of the OECS and the key challenges they face in achieving sustainable economic development, I will turn to the potential costs and benefits of participation in a Free Trade Area of the Americas (FTAA) Agreement. In particular, I will emphasize how the FTAA offers governments who are currently unable to promote essential reforms, the opportunity to use the Agreement as the impetus for the reforms and as a means of balancing the interests of those who will gain and those who will lose in the short-run.

THE OECS AND THEIR CHALLENGES:

The Organization of Eastern Caribbean States was formed in 1981 to foster cooperation among member states of the region. Today, the OECS includes six independent states (Antigua and Barbuda, Dominica, Grenada, St Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines) and three British Territories (Anguilla, the British Virgin Islands, and Montserrat). The current population in the Eastern Caribbean is estimated at just over 600,000. For years now, skilled workers have migrated in search of better jobs in Canada, the US, Europe and elsewhere.

The combined Gross Domestic Product of the OECS is around US $3.5 billion, and the most significant contributions stem from agriculture, tourism, offshore financial services and light manufacturing. However, for the last couple of years, each of these sectors have been under pressure:

Agriculture in the Caribbean has always been vulnerable to the tropical storms that affect the region. Furthermore, this sector has been severely hampered by the loss of trade preferences in bananas and sugar, and by difficulties in diversifying production due to diseconomies of scale, inadequate distribution networks, lack of investment, and relatively high labour costs.

Tourism accounts for about 60% of foreign exchange earnings in the Eastern Caribbean States. This industry is currently threatened by lower-cost competitors in Cuba and the Dominican Republic. This sector is also threatened by reduced air service and increased transportation costs to the islands, following September 11th 2001. The tourism industry in some countries also lacks the appropriate tourism infrastructure, such as sufficient hotel choices and good quality roads.

Offshore financing experienced rapid growth throughout the 1990s, was recently hard hit by the OECD Financial Action Task Force. This task force, in an attempt to limit the laundering of funds from criminal or terrorist organizations, has blacklisted several OECS countries because they were seen as havens for tax evasion and money laundering.

As a result, OECS jurisdictions have become increasingly compliant, and have lost much of their attraction as offshore financial centres.

Light manufacturing consists of transforming imported inputs into goods for domestic consumption. This industry remains uncompetitive and is under threat by lower cost imports from foreign producers who are able to take advantage of scale economies.

As OECS members respond to their WTO obligations by reducing import duties and opening their markets to a wider range of goods and services, few businesses expect to be able to compete in the short to medium term. There is widespread agreement that if the OECS is to compete internationally, the islands must reorient their activities towards niche markets, and invest heavily into air and seaports, roads and telecommunications infrastructure.

Unfortunately, this reorientation is increasingly difficult due to the economic downturn in the region following the US recession in 2001. These difficulties are further exacerbated by a seemingly continuous chain of crises, like September 11th, the war in Iraq, and SARS. Poor economic growth has further reduced OECS governments' abilities to manage their books and maintain revenues for the delivery of government services. In other words, fiscal management is a key challenge for most governments. Furthermore, all of the islands are heavily indebted to external sources, and foreign funds, either through donor grants or through loans, is limited. Most OECS countries are in significant deficit situations, and many lack sufficient revenue to cover current expenditures. Dominica and Antigua and Barbuda have been the focus of recent media attention as their governments strive to pay their bills. Dominica is implementing an IMF-led stabilization program, and the IMF has proposed similar programs to St. Lucia and to Antigua and Barbuda.

It is always the poorest people, those who rely on government services who are the most at risk from the failure of their governments to maintain fiscal discipline and to ensure that revenues are targeted towards priority areas such as health, education and social safety nets.

THE NEED FOR REFORM:

The OECS has sufficiently underlined the special characteristics of small island states in the context of an increasingly globalized and interdependent world. They are small island states with few workers, investors, entrepreneurs and bureaucrats. Their distance from major markets result in high transportation costs, and their geographical location makes them vulnerable to natural disasters.

Their individual economies have relatively little aggregate purchasing power, and therefore cannot take advantage of lower-cost bulk purchases. Furthermore, they do not attract foreign investors looking to serve local markets, which makes them excessively dependent on the export of goods and services, such as agricultural products and the tourism trade.

These difficulties, along with historical patterns of preferential access to European markets, have resulted in government policies that constrain innovation in the private sector and maintain excessive dependence on import duties. However, import duties raise the prices of goods and services required by both consumers and producers in the OECS, forcing them to pay too much, earn too little, and contribute minimal tax revenues to the government.

Many of the reforms identified as essential for addressing these challenges, such as limiting government spending, reducing the size and improving the efficiency of the bureaucracy, reforming tax policies and administration, and diversifying sources of government revenue, are technically challenging and politically contentious. Therefore, while there appears to be widespread consensus that something has to be done, very few governments have been willing to challenge the status quo. The problem is that the status quo is a dead end. More and more people will leave their countries in search of opportunities elsewhere, and the OECS might become increasingly marginalized and economically isolated.

In other words, even in the absence of an FTAA or another regional economic integration mechanisms, the OECS will have to address the structural weaknesses of their economies and develop local solutions that will enable them to maintain economic independence.

I will now argue that the FTAA provides an opportunity for governments to challenge the status quo and defend their national interests.

There will be significant changes brought about by reductions in import duties and increased market access for foreign producers. As barriers come down, lower cost imports of goods and services may force some local businesses into bankruptcy, which will increase unemployment, reduce earnings and reduce economic demand. Furthermore, as tariff revenues decline, governments may have fewer resources with which to respond to urgent social and economic priorities.

However, these same reforms will likely induce some beneficial changes. Lowering tariffs and market restrictions will mean better access for consumers and producers to a greater variety of goods and services, at a lower cost and of higher quality. These lower cost goods and services should increase consumers spending power, which may increase economic demand. Furthermore, lower costs and higher quality inputs should lower the production costs for domestic producers. In addition to reducing the prices of their domestically produced goods and services, these producers may be able to absorb some of the workers from uncompetitive sectors.

Increased domestic productivity and the lower cost of doing business should attract more foreign investors, who will inject capital and new business techniques, and further absorb some of the lost employment.

There is also a possibility that some of the reforms will be neutral. For example, although tariff rates will fall, the total impact on government tariff revenues may be negligible in the short-term. There are two reasons for this: while governments reduce tariff rates, they can also improve the efficiency of tariff revenue collection. The improved collection of revenues will counter some of the losses associated with falling rates. Furthermore, if consumer demand is highly responsive to price changes for certain goods, then a reduction in the price of the goods (as their tariffs are reduced) may result in a significant increase in the demand for the goods, so that the sum total of tariff revenues may not change significantly.

Even if one were to accept the worst fears of the OECS, namely that their revenue sources could be significantly reduced, and domestic firms undermined by international competition, the current dependence on tariff revenues, the fiscal and economic governance structures provide few incentives for competitive innovation.
Furthermore, support for established businesses through tax breaks and government contracts, imposes unacceptably high costs on the more vulnerable segments of OECS populations (who need to use their scarce dollars and cents to pay for the artificially-expensive food and household goods).

Ultimately, the status quo condemns OECS countries to perpetual cycles of economic dependency, donor resources and emergency bailouts. It also condems the poor in those countries to ongoing vulnerability.

That doesn't change the fact that there will be losers in the FTAA process in the short to medium term, and that the process of adjusting to an integrated hemispheric economy will be difficult for many people. The challenge will be to strike a balance between the legitimate concerns of those who will suffer in the short-term, and the corporate interests, whose insistence on the status quo perpetuates an unsustainable system.

The private sector will have to encourage new local entrepreneurs with the foresight and skills to take advantage of new business opportunities, and away from established enterprises that have relied on protected markets and have not responded to changing conditions. It is under these circumstances that the FTAA can balance the needs of the winners and losers, and provide the political capital to encourage these essential reforms.

In the face of surmounting opposition to change, governments will be able to claim that they had to allow market access and other reforms as a result of their FTAA obligations. Blaming the reforms on the FTAA will allow the governments to avoid personal responsibility for tackling what would otherwise be an insurmountable constraint to future growth. Government concessions will be balanced by a package of economic deliverables with real promises for change. As discussed above, an FTAA will provide domestic businesses and entrepreneurs with new, expanded and unconditional access to the world's largest and most prosperous market economy, along with better prices and higher quality goods for domestic consumers and producers, a prerequisite for becoming competitive in new markets, and improving possibilities for attracting foreign investors.

Governments negotiating the FTAA will also be equipped with broad-based trade-related support. The Hemispheric Cooperation Program is aimed at providing trade-related technical assistance and capacity building for the implementation of FTAA obligations in order to maximize the benefits during the transition to hemispheric integration.

This is the heart of my argument. The reforms required by the OECS are essential for their economic survival. The FTAA, in delivering a number of potential benefits, provides the rationale for pursuing these reforms, and enables governments to balance the interests of different groups. At the same time, the Hemispheric Cooperation Program and supportive donors will provide the OECS with much of the assistance and capacity building required to address their specific challenges and constraints as small island states.