

# **Attracting Investments in Developing Countries: Possibilities and Difficulties**

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## 1. Introduction

A review of the possibilities and difficulties with attracting investments into developing countries, in particular those in the CARICOM region, can hardly commence without reference to the developments that have taken place in the world economy, especially over the past two decades. This period has been marked by an increased mobility of resources in the form of capital, information, technology or people mainly through the medium of trade and investment, driven or accompanied by the transnational economic activity of business enterprises.

These developments - usually subsumed under the term "globalisation" - have brought about the increasing integration of national economies whereby countries are being drawn into a web of relationships within which purely domestic or national considerations are becoming less relevant in determining the range of options available to policy makers in shaping the direction of their economies.

Though globalisation is manifest in the significant growth in worldwide trade and investment, it is often associated more with the dramatic growth in foreign direct investment (FDI)<sup>1</sup>, particularly that undertaken through the activities of the more than 60,000 TNCs and their affiliates numbering over 800,000. One of the responses by States to globalisation has thus been the desire to ensure that they derive their fair share of the benefits through the creation of a conducive environment for the attraction of such investment.

This observation is equally true of countries in the CARICOM region which, like all other countries, face the challenges of a globalising world. Thus many of the reforms initiated by them, particularly since the early 1990s, have been inspired by the need to open up their economies to enable them reap the benefits of greater integration with the rest of the world. This has been especially manifest in the areas of trade, investment and financial relations. Measures undertaken by them have included the relaxation of capital controls and international trade restrictions and the conclusion of bilateral investment agreements with investor home states. More recently, there are moves towards the creation of a CARICOM Single Market and Economy (CSME) as a means of, among other things, enhancing the attractiveness of the region for increased resource flows.

The need to attract private capital in the form of FDI in order to sustain and enhance their development has been made even more urgent by the dwindling flows of official development assistance (ODA) on which many countries in the region have relied in the past, the gradual withdrawal of preferential trade arrangements under which their goods have enjoyed easier

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<sup>1</sup> The term 'foreign direct investment' (FDI) is used throughout this paper to refer to the transfer by an investor of assets, whether in the form of capital, technology or skills into another country to be used for income generating activities. It entails the active participation of the investor in the management and type of investment activities conducted. The term is used in the general literature in contradistinction to 'foreign portfolio investment', which refers to the participation in such income generating activities, usually through the purchase of securities or through loans or the licensing of technology, without any active involvement in the manner in which such activities are conducted. Although a significant part of capital inflows to developing countries can take the form of short term loans and portfolio equity, these tend to be an unreliable source for obtaining development finance as they are unstable and tend to be liquid capital in search of profit arbitrage opportunities.

access to some foreign markets, and the decreasing revenue from trade following the progressive liberalization of their trade regimes.

Thus the question they face what possibilities exist for attracting investment - particularly FDI - and what difficulties they have encountered or are likely to encounter in that regard. These are the questions sought to be addressed in this paper.

The latter part of the paper is devoted to the issue of the multilateral tax agreement concluded between the CARICOM members in 1994, which has been the subject of a number of articles. As a follow-up to the IBFD presentation on the subject at the previous COTA Conference, this paper will briefly review the problems identified in the agreement and suggest possible solutions to them.

## **2. FDI Trends in the CARICOM Region**

As a background to the consideration of these issues, the paper first reviews the trends in FDI inflows over the years involving countries in the region.

### ***2.1. Aggregate Investment Inflows***

Worldwide FDI inflows into all regions for the years 1989 – 2000 is presented in Table 1.

Table 1 - FDI Inflows, 1989 - 2000 (millions of dollars)

| Host region/economy                          | 1989-1994<br>(Annual average) | 1995             | 1996               | 1997               | 1998               | 1999               | 2000               |
|--|-------------------------------|------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
| <b>World</b>                                 | <b>200,145</b>                | <b>331,068</b>   | <b>384,910</b>     | <b>477,918</b>     | <b>692,544</b>     | <b>1,075,049</b>   | <b>1,270,764</b>   |
| <b>Developed countries</b>                   | <b>137,124</b>                | <b>203,462</b>   | <b>219,688</b>     | <b>271,378</b>     | <b>483,165</b>     | <b>829,818</b>     | <b>1,005,178</b>   |
| <b>Developing countries and economies</b>    | <b>59,578</b>                 | <b>113,338</b>   | <b>152,493</b>     | <b>187,352</b>     | <b>188,371</b>     | <b>222,010</b>     | <b>240,167</b>     |
| <b>Africa</b>                                | <b>3,952</b>                  | <b>4,694</b>     | <b>5,622</b>       | <b>7,153</b>       | <b>7,713</b>       | <b>8,971</b>       | <b>8,198</b>       |
| <b>Latin America and the Caribbean</b>       | <b>17,506</b>                 | <b>32,311</b>    | <b>51,279</b>      | <b>71,152</b>      | <b>83,200</b>      | <b>110,285</b>     | <b>86,172</b>      |
| <b>South America</b>                         | <b>7,647</b>                  | <b>19,546</b>    | <b>30,694</b>      | <b>45,264</b>      | <b>53,303</b>      | <b>75,863</b>      | <b>55,081</b>      |
| <b>Other Latin America and the Caribbean</b> | <b>9,859</b>                  | <b>12,765</b>    | <b>20,585</b>      | <b>25,889</b>      | <b>29,898</b>      | <b>34,422</b>      | <b>31,090</b>      |
| Anguilla                                     | 10 <sup>b</sup>               | 18               | 33                 | 21                 | 28                 | 40                 | 48 <sup>a</sup>    |
| Antigua and Barbuda                          | 36                            | 31               | 19                 | 23                 | 27                 | 27                 | 31 <sup>a</sup>    |
| Aruba  | 34                            | 1                | 84                 | 196                | 84                 | 392                | -228               |
| Bahamas                                      | 10                            | 107              | 88                 | 210                | 147                | 149                | 251                |
| Barbados                                     | 11                            | 12               | 13                 | 15                 | 16 <sup>i</sup>    | 17                 | 14 <sup>a</sup>    |
| Belize                                       | 16                            | 21               | 17                 | 12                 | 19                 | 56                 | 28                 |
| Bermuda                                      | 1,553                         | 641 <sup>a</sup> | 3,971 <sup>a</sup> | 2,928 <sup>a</sup> | 5,395 <sup>a</sup> | 6,443 <sup>a</sup> | 6,648 <sup>a</sup> |
| Cayman Islands                               | 179                           | 42 <sup>a</sup>  | 1,232 <sup>a</sup> | 3,151 <sup>a</sup> | 4,348 <sup>a</sup> | 6,468 <sup>a</sup> | 4,783 <sup>a</sup> |
| Dominica                                     | 17                            | 54               | 18                 | 21                 | 7                  | 18                 | 16 <sup>a</sup>    |
| Dominican Republic                           | 161                           | 414              | 97                 | 421                | 700                | 1,338              | 953                |
| Grenada                                      | 17                            | 20               | 19                 | 35                 | 51                 | 46                 | 37 <sup>a</sup>    |
| Haiti  | 4                             | -2               | 4                  | 4                  | 11                 | 30                 | 13                 |
| Jamaica                                      | 144                           | 147              | 184                | 203                | 369                | 524                | 456                |
| Montserrat                                   | 6                             | 3                | -                  | 3                  | 3                  | 8                  | 2 <sup>a</sup>     |
| Netherlands Antilles                         | 22                            | 10               | 2,826 <sup>a</sup> | 1,038 <sup>a</sup> | 892 <sup>a</sup>   | 401 <sup>a</sup>   | 777 <sup>a</sup>   |
| Saint Kitts and Nevis                        | 25                            | 20               | 35                 | 20                 | 32                 | 42                 | 38 <sup>a</sup>    |
| Saint Lucia                                  | 39                            | 33               | 18                 | 48                 | 83                 | 94                 | 75 <sup>a</sup>    |
| Saint Vincent and the Grenadines             | 20                            | 31               | 43                 | 92                 | 89                 | 46                 | 76 <sup>a</sup>    |
| Trinidad and Tobago                          | 250                           | 299              | 355                | 1,000              | 732                | 643                | 662                |
| Virgin Islands                               | 186                           | 470              | 510                | 500                | 1,348 <sup>a</sup> | 3,656 <sup>a</sup> | 1,483 <sup>a</sup> |

Source: UNCTAD, World Investment Report 2001, at 291-295.

a Estimates

b Annual average from 1991 to 1994

Table 1 shows that FDI inflows into the CARICOM region has generally experienced an increasing trend over the past decade, tripling in size between 1989 - 2000. However, the share of the region in total worldwide FDI inflows remains insignificant. As is evident from the table, the greater share of such flows is concentrated in the developed countries.

The breakdown in respective country shares of aggregate FDI inflows, however, reveals that some countries have been more successful than others in attracting investment. Of these, Bermuda and the Cayman Islands would appear to top the list this will have to be interpreted in the light of the fact that the final destination of the majority of flows received by financial centres might not

be the countries themselves, but other countries within and outside the region.

## **2.2. Inward FDI Flows, as Percentage of World Total**

The significance of FDI inflows into the CARICOM region is more sharply revealed when one views the percentage share of that region in global FDI inflows, along with its share of global GDP and exports. This is presented in Table 2.

**Table 2 - Share of Regions in global FDI inflows, GDP and exports, 1988 - 1990 and 1998 - 2000**

| Region                                    | FDI inflows |             | GDP         |             | Exports     |             |
|---|-------------|-------------|-------------|-------------|-------------|-------------|
|   | 1988-1990   | 1998-2000   | 1988-1990   | 1998-1999   | 1988-1990   | 1998-1999   |
| <b>Developed countries</b>                | <b>82.7</b> | <b>76.3</b> | <b>79.9</b> | <b>76.8</b> | <b>73.6</b> | <b>68.4</b> |
| Western Europe                            | 43.3        | 45.3        | 32.2        | 29.6        | 45.6        | 41.8        |
| European Union                            | 41.4        | 43.8        | 30.6        | 28.2        | 42.6        | 39.4        |
| Other developed countries                 | 39.4        | 31.0        | 47.7        | 47.2        | 28.0        | 26.6        |
| <b>Developing countries and economies</b> | <b>17.1</b> | <b>21.4</b> | <b>17.7</b> | <b>20.8</b> | <b>21.9</b> | <b>27.5</b> |
| Africa                                    | 1.8         | 0.8         | 1.7         | 1.4         | 2.4         | 1.6         |
| Latin America and the Caribbean           | 4.7         | 9.2         | 5.2         | 6.9         | 4.3         | 5.1         |
| South America                             | 2.5         | 6.1         | 3.7         | 4.9         | 2.5         | 2.4         |
| Other Latin America and the Caribbean     | 2.1         | 3.2         | 1.6         | 2.0         | 1.7         | 2.7         |
| Asia and the Pacific                      | 10.6        | 11.1        | 10.2        | 12.3        | 14.7        | 20.4        |
| <b>Central and Eastern Europe</b>         | <b>0.2</b>  | <b>2.3</b>  | <b>2.4</b>  | <b>2.5</b>  | <b>4.5</b>  | <b>4.1</b>  |

Source: UNCTAD, World Investment Report 2001, at 256.

We see from Table 2 that overall, the share of the Caribbean in worldwide FDI inflows, GDP and exports is rather low. This, however, has to be viewed in terms of the relative size of the region (e.g. population and economy).

## **2.3. Inward FDI as a Percentage of GFCF**

The bare presentation of the share of the region in total worldwide FDI inflows does not reflect the relative significance of such flows for the region. One measure used in determining such significance is the percentage share of such flows in the gross fixed capital formation (GFCF) of the host region/country. Gross fixed capital formation refers to investments made in fixed assets, for example, expenditure on buildings, vehicles, plant and machinery for replacing or adding to the stock of existing fixed assets. The position of the region on this score compared to the rest of the world is presented in Table 3.

Table 3 - Inward FDI flows as a percentage of GFCF, 1989 – 1999

| Region   | 1989-1994<br>(Annual Average) | 1995        | 1996        | 1997        | 1998        | 1999        |
|--|-------------------------------|-------------|-------------|-------------|-------------|-------------|
| <b>World</b>   | <b>4.1</b>                    | <b>5.3</b>  | <b>5.9</b>  | <b>7.5</b>  | <b>10.9</b> | <b>16.3</b> |
| <b>Developed countries</b>                           | <b>3.7</b>                    | <b>4.4</b>  | <b>4.8</b>  | <b>6.1</b>  | <b>10.6</b> | <b>17.0</b> |
| <b>Developing countries<br/>and economies</b>        | <b>5.2</b>                    | <b>7.7</b>  | <b>9.1</b>  | <b>10.9</b> | <b>11.7</b> | <b>13.8</b> |
| <b>Africa</b>  | <b>5.8</b>                    | <b>6.7</b>  | <b>7.6</b>  | <b>9.1</b>  | <b>8.8</b>  | <b>10.4</b> |
| <b>Latin America and<br/>the Caribbean</b>           | <b>6.2</b>                    | <b>9.6</b>  | <b>12.3</b> | <b>15.9</b> | <b>17.6</b> | <b>27.3</b> |
| <b>South America</b>                                 | <b>4.5</b>                    | <b>7.4</b>  | <b>11.3</b> | <b>15.1</b> | <b>18.1</b> | <b>35.4</b> |
| <b>Other Latin<br/>America and the<br/>Caribbean</b> | <b>10.2</b>                   | <b>18.5</b> | <b>15.7</b> | <b>18.4</b> | <b>16.1</b> | <b>13.5</b> |
| Antigua and Barbuda                                  | 25.0                          | 17.3        | 9.0         | 10.1        | 10.3        | 8.9         |
| Aruba  | ..                            | ..          | ..          | ..          | ...         | ..          |
| Bahamas  | 1.6                           | 15.3        | 14.3        | 32.7        | 22.6        | 23.5        |
| Barbados   | 4.7                           | 4.5         | 5.3         | 4.4         | 5.5         | 5.9         |
| Belize   | 12.9                          | 16.0        | 12.1        | 8.2         | 12.4        | 27.5        |
| Dominica   | 28.8                          | 74.6        | 25.4        | 26.1        | 8.6         | 23.9        |
| Dominican Republic                                   | 8.8                           | 18.1        | 3.9         | 14.3        | 19.1        | 31.0        |
| Grenada  | 21.0                          | 22.5        | 18.7        | 30.7        | 39.9        | 30.9        |
| Guyana   | 26.3                          | 26.4        | 30.0        | 15.9        | 22.5        | 17.1        |
| Haiti  | -                             | -0.7        | 1.0         | 1.0         | 2.4         | 5.7         |
| Jamaica  | 12.7                          | 8.9         | 9.8         | 9.4         | 18.6        | 26.1        |
| Saint Kitts and Nevis                                | 31.0                          | 24.2        | 31.2        | 16.3        | 25.9        | 37.8        |
| Saint Lucia  | 35.2                          | 31.2        | 15.1        | 33.4        | 70.9        | 73.8        |
| Saint Vincent and<br>the Grenadines                  | 33.8                          | 38.5        | 54.1        | 106.2       | 88.3        | 51.5        |
| Suriname   | -22.9                         | -7.7        | 6.6         | -2.9        | 3.1         | -6.1        |
| Trinidad and Tobago                                  | 32.3                          | 37.0        | 37.3        | 65.2        | 46.9        | 47.7        |

Source: UNCTAD, *World Investment Report 2001* at 312 – 324.

Table 3 reveals that the performance of countries in the CARICOM region as a whole has generally been much higher than that of other countries and regions (both developing and developed) of the world. A breakdown in the country by country performance reveals differences among the countries within the region itself, with many of these far exceeding the regional average.

#### **2.4. FDI Inward Stocks as Percentage of GDP**

Yet another indicator of the significance of inward and outward FDI is the share of FDI stock as a percentage of the gross domestic product (GDP) of the host State. The position of the CARICOM region, compared to the rest of the world, is presented in Table 4.

Table 4 - Inward FDI stocks as a percentage of GDP, 1980, 1985, 1990, 1995 and 1999

| Region/economy                               | 1980        | 1985        | 1990        | 1995        | 1999        |
|--|-------------|-------------|-------------|-------------|-------------|
| <b>World</b>                                 | <b>6.0</b>  | <b>7.8</b>  | <b>9.2</b>  | <b>10.3</b> | <b>17.3</b> |
| <b>Developed countries</b>                   | <b>4.7</b>  | <b>6.1</b>  | <b>8.4</b>  | <b>9.2</b>  | <b>14.5</b> |
| <b>Developing countries and economies</b>    | <b>10.2</b> | <b>14.1</b> | <b>13.4</b> | <b>15.6</b> | <b>28.0</b> |
| <b>Africa</b>                                | <b>4.6</b>  | <b>7.4</b>  | <b>11.1</b> | <b>18.2</b> | <b>21.0</b> |
| <b>Latin America and the Caribbean</b>       | <b>6.5</b>  | <b>10.9</b> | <b>10.3</b> | <b>11.8</b> | <b>25.6</b> |
| <b>South America</b>                         | <b>6.0</b>  | <b>9.0</b>  | <b>8.5</b>  | <b>8.5</b>  | <b>23.3</b> |
| <b>Other Latin America and the Caribbean</b> | <b>7.2</b>  | <b>14.5</b> | <b>14.6</b> | <b>22.6</b> | <b>31.2</b> |
| Anguilla                                     | ..          | ..          | 54.1        | 275.9       | 660.9       |
| Antigua and Barbuda                          | 20.9        | 46.5        | 74.5        | 88.6        | 92.1        |
| Aruba  | ..          | ..          | 15.2        | 16.5        | 79.3        |
| Bahamas                                      | 39.2        | 22.4        | 18.1        | 20.8        | 33.3        |
| Barbados                                     | 11.8        | 10.3        | 9.9         | 12.1        | 13.2        |
| Belize                                       | 6.3         | 4.9         | 18.1        | 26.0        | 36.2        |
| Bermuda                                      | 837.1       | 774.3       | 871.0       | 1176.3      | 1936.2      |
| Cayman Islands                               | ..          | ..          | 355.5       | 395.5       | 2075.9      |
| Dominica                                     | 0.1         | 10.7        | 42.9        | 88.5        | 108.0       |
| Dominican Republic                           | 3.6         | 5.9         | 8.1         | 14.3        | 24.9        |
| Grenada                                      | 1.7         | 9.8         | 31.7        | 60.6        | 106.6       |
| Guyana                                       | -           | -           | -           | 58.9        | 93.4        |
| Haiti  | 5.4         | 5.6         | 5.0         | 5.8         | 5.2         |
| Jamaica                                      | 18.7        | 22.7        | 17.1        | 28.6        | 45.4        |
| Netherlands Antilles                         | 62.3        | 2.5         | 11.4        | 11.9        | 231.7       |
| Saint Kitts and Nevis                        | 2.1         | 40.5        | 102.0       | 104.8       | 122.2       |
| Saint Lucia                                  | 70.1        | 90.7        | 75.7        | 93.4        | 119.4       |
| Saint Vincent and the Grenadines             | 2.0         | 7.5         | 24.4        | 68.9        | 157.9       |
| Suriname                                     | -           | 4.1         | -           | -           | -           |
| Trinidad and Tobago                          | 15.7        | 23.7        | 41.3        | 68.4        | 90.9        |
| Virgin Islands                               | 0.2         | 3.9         | 15.3        | 87.2        | 408.2       |

Source: UNCTAD, *World Investment Report 2001*, at 325 - 337.

We see in Table 4 that, as in the case of the measurement of inward FDI as a percentage of GFCF, the performance of countries in the region generally exceeds that of other regions in the world, with specific country positions being remarkably higher than the average.

### **2.5. Other Measurements**

Other measurements of the relative importance of FDI to a host country or region, or the extent to which that country or region may be said to be integrated into the global economy include the “transnationality index” (i.e. the average of (a) FDI inflows as a percentage of GFCF (b) FDI inward stock as a percentage of GDP (c) value added of foreign affiliates as a percentage of GDP and (d) employment of foreign affiliates as a percentage of total employment) and the number of parent corporations and foreign affiliates in the host economy. Comprehensive data on these measurements have yet to be compiled, but the limited studies conducted reveal that a number of countries within the CARICOM region occupy prominent positions in a ranking of countries on this score. For example, on the list of the top 30 developing countries for which the transnationality index is measured are the Bahamas, Dominican Republic, Jamaica and Barbados in 7<sup>th</sup>, 14<sup>th</sup>, 16<sup>th</sup> and 26<sup>th</sup> position

respectively.<sup>2</sup>

### **3. Investment Possibilities and Difficulties in the CARICOM Region**

#### ***3.1. The Underlying Attractiveness of the CARICOM Region***

One measure that is used to ascertain the underlying attractiveness of a country or region for international investors is the “inward FDI index”. This measurement is made on the basis of an assessment of the host country’s relative economic size and strength. The index consists of the average of three ratios, showing the country’s share in world FDI relative to its shares in GDP, employment and exports. Thus an index value of “one” means that a country’s share in world FDI matches its economic position when judged with reference to these three indicators.<sup>3</sup>

Though by no means a perfect measure of a country/regions attractiveness - for example, the FDI index does not account for other important locational factors such as political risk, government policy and international perceptions - it provides yet another tool for assessing how well particular regions or countries are performing relative to others in attracting FDI. The position of the CARICOM region vis-à-vis other regions in this respect is presented in Table 5.

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<sup>2</sup> UNCTAD, above note 3 at 38.

<sup>3</sup> UNCTAD, *World Investment Report 2001. Promoting Linkages* (Geneva: United Nations, 2001), at 39 - 43.

**Table 5 - Inward FDI Index, by region, 1988-1990 and 1998-2000**

| Region                                | 1988 - 1990                          |  |   |                        | 1998 - 2000                          |  |   |                        |
|---------------------------------------|--------------------------------------|--|---|------------------------|--------------------------------------|--|---|------------------------|
|                                       | FDI share/<br>GDP share <sup>a</sup> | FDI share/<br>employment<br>share <sup>b</sup> | FDI share/<br>export share <sup>c</sup> | FDI<br>inward<br>index | FDI share/<br>GDP share <sup>a</sup> | FDI share/<br>employment<br>share <sup>b</sup> | FDI share/<br>export share <sup>c</sup> | FDI<br>inward<br>index |
| <b>World</b>                          | <b>1.0</b>                           | <b>1.0</b>                                     | <b>1.0</b>                              | <b>1.0</b>             | <b>1.0</b>                           | <b>1.0</b>                                     | <b>1.0</b>                              | <b>1.0</b>             |
| <b>Developed economies</b>            | <b>1.0</b>                           | <b>4.0</b>                                     | <b>1.1</b>                              | <b>2.0</b>             | <b>1.0</b>                           | <b>4.4</b>                                     | <b>1.1</b>                              | <b>2.2</b>             |
| <b>Developing economies</b>           | <b>1.0</b>                           | <b>0.2</b>                                     | <b>0.7</b>                              | <b>0.6</b>             | <b>1.0</b>                           | <b>0.3</b>                                     | <b>0.7</b>                              | <b>0.7</b>             |
| Africa                                | 1.0                                  | 0.2  | 0.7                                     | 0.6                    | 0.7                                  | 0.1  | 0.6                                     | 0.4                    |
| Latin America and the Caribbean       | 0.8                                  | 0.6  | 1.0                                     | 0.8                    | 1.1                                  | 1.0  | 1.6                                     | 1.2                    |
| South America                         | 0.7                                  | 0.5  | 1.0                                     | 0.7                    | 1.2                                  | 1.1  | 2.6                                     | 1.6                    |
| Other Latin America and the Caribbean | 1.2                                  | 0.8  | 1.1                                     | 1.0                    | 0.9                                  | 0.7  | 0.6                                     | 0.7                    |
| Asia and the Pacific                  | 1.1                                  | 0.2  | 0.6                                     | 0.6                    | 0.9                                  | 0.2  | 0.6                                     | 0.6                    |
| Developing Europe                     | 2.2                                  | 3.4  | 0.5                                     | 2.1                    | 1.2                                  | 1.5  | 0.6                                     | 1.1                    |
| <b>Central and Eastern Europe</b>     | <b>0.2</b>                           | <b>0.1</b>                                     | <b>0.2</b>                              | <b>0.1</b>             | <b>0.9</b>                           | <b>0.4</b>                                     | <b>0.6</b>                              | <b>0.6</b>             |

Source: UNCTAD, World Investment Report 2001, at 43.

a The ratio of the region's share of world FDI inflows to the region's share of world GDP.

b The ratio of the region's share of world FDI inflows to the region's share of world employment.

c The ratio of the region's share of world FDI inflows to the region's share of world exports of goods and services.

It is evident from Table 5 that while the index for Latin American and the Caribbean region as a whole for the most recent period (i.e. 1998 - 2000) exceeds the unit of 1 - thus showing an attraction matching their economic position, that for the sub-set of CARICOM countries (mostly included in the category of "Other Latin America and Caribbean") generally falls short of that standard, and when compared to the measurement taken the decade before, shows a weakening in their position. It may be concluded from this limited analysis then that there is room for CARICOM countries to enhance their ability to attract FDI. Of course, the composite view masks the differences that are certain to exist in the position of particular countries within the region, but the non-availability of data for each country prevents a more detailed analysis.

It is therefore appropriate to consider what the possibilities for increased investment in the region are. Any such consideration must, however, be premised on the realisation that countries in the region, although they share certain characteristics (e.g. small geographic and population size), do not constitute a homogenous whole; rather, they vary in several respects, particularly in terms of their human and natural resource endowments. Economies in the region are broadly categorized as being either natural resource based (e.g. Belize, Guyana, Suriname and Trinidad and Tobago) or services oriented (e.g. Antigua and Barbuda, the Bahamas, Barbados, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines and Haiti) or a combination of these two (e.g. Jamaica and the Dominican Republic). A certain degree of diversification, however, exists even in the case of countries that are regarded as natural resource based or services oriented.<sup>4</sup> The investment possibilities of countries in the region can therefore be expected to lie in areas where the country enjoys a comparative advantage, or in the promotion of areas where the country is likely to enjoy such an advantage.

We shall consider the areas or sectors where countries in the region have developed the strengths that are likely to attract investment, or desire to do achieve such strengths, and review what possibilities or difficulties exist or are likely to be encountered in their bid for increased FDI flows into these sectors. The focus is on 3 main sectors: tourism, financial services and export-oriented technology-based industry.

### **3.2. Tourism**

The image of the Caribbean region as a prime tourist destination is well established. Many countries in the region are well endowed with the natural resources suited for activities in this sector, including clean, sandy beaches, other natural resource attractions (flora and fauna) and a hospitable climate and people. For many of these countries, tourism remains one of the most significant contributors to employment, GDP and foreign exchange earnings.

That tourism still holds potential for increased foreign investment in the CARICOM region is not to be doubted. There is no mention in the general literature that countries in the region have exhausted their potential to attract increased investment into this sector. The sector therefore remains a prime target for foreign investment attraction – a recognition which reflected in the

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<sup>4</sup> Carrington, E., "Inward Investment Opportunities in the Caribbean for European Union Investors", Paper prepared as contribution to CARIBINVEST, June 1999.

pronouncements of governments in the region.

One feature of tourism that makes the sector particularly appealing in terms of the attraction of investment is the non-tradability of the core service offered. This means that investors are compelled to invest their resources close to the market or the consumer, in contrast to other services, (e.g., insurance and banking) where advances in technology have made physical proximity between the producer and consumer of less relevance.

However, a potential difficulty with attracting investment into the tourism sector, like many other service sectors, lies in the import intensity of that sector. This can give rise to leakage problems, especially in the case of luxury tourism under franchises in low-income countries. This follows from the fact that capital and consumption goods not available locally will have to be imported, and profits remitted, thus cutting into any export earnings generated from tourism.

Another difficulty is that in view of their high reliance on the tourism sector, governments in the region become more severely affected by any external events that may have a negative impact on the tourist sector worldwide. The prime example in recent memory is the terrorist attacks of September 11 in the US, which had negative consequences for the tourism industry. In St. Lucia, for example, the government reported in its 2002 Budget that stay-over visitor arrivals declined by more than twenty thousand and total tourist expenditure dropped by around \$122.3 million in the aftermath of these attacks.

### **3.3. Financial Services**

Another area in which many countries in the CARICOM region have developed some expertise that has served to attract investment flows is in the financial services sector. With small lands and populations, limited natural resources and limited access to international capital markets, the promotion of this sector has emerged as a viable option for generating income and employment. The sector typically involves the creation of an enabling environment for the operations of economic agents such as international business companies (IBCs), banks, mutual funds, international trusts and insurance companies.

Estimates show that the offshore sector is making a significant contribution in terms of revenue generation and employment to the countries in the region with a vibrant offshore sector, although the extent of such contributions varies from country to country. For example, fees from the registration or licensing of business entities or activities are estimated to have amounted to about 20% of government revenue in the Bahamas in 1999.

The main problem associated with attracting investments into this sector, however, is that very little economic activity requiring a significant degree of physical presence is required. Rather, income generation in the sector appears to be mainly from registration and licensing fees. And although many of the countries' laws requires a certain degree of presence (e.g. in the form of a registered office or agent), not much else appears to be needed to conduct business in the forms permitted. Consequently, the capital the sector attracts is more in the nature of liquid assets that can easily be shifted from jurisdiction to jurisdiction. Such a form of investment cannot reasonably be

considered to be reliable in terms of long-term growth.

Perhaps the greatest difficulty with attracting investments into the financial services sector has to do with the concerns of many developed countries that such measures could operate to their detriment – in particular the erosion of their tax base – by providing attractive avenues for the accumulation of income or assets out of reach of their tax administrations and hence essentially becoming tools for effective tax avoidance or evasion by their residents. OECD Member States have been particularly vocal in expressing their reservations about activities in this sector and have sought therefore to limit their effects through measures designed to curtail such “harmful tax competition”.

Tax competition is considered desirable if it leads governments to refine their approach to investment promotion, thereby selecting the most efficient instruments for such promotion. Competition belonging to the harmful category is thought to include measures that increase opportunities for international tax avoidance, lead to waste or the international misallocation of resources and create spillover effects that limit the ability of other countries to maintain taxes that are both desirable from a tax policy perspective and lie within a country’s effective jurisdiction.

To avoid being subject to sanctions designed by the OECD to counter such harmful tax competition, several States in the Caribbean have had to commit themselves to achieving certain goals by December 2005. These include the adoption of a plan to achieve international standards in the area of transparency and exchange of information; the availability of beneficial ownership of companies, partnerships and other entities; the financial books and record keeping; effective exchange of information on criminal matters; transparency of the tax system; effective exchange of information on all tax matters and access to bank information; and not attracting business without substantial domestic activity.

Thus while many countries in the region are limited in their options as to sectors of strength for attracting FDI, their experience with financial service sector promotion has shown that they do not have a free hand in developing a sector in which they see themselves as enjoying a comparative advantage. Consequently, although many of them have agreed to cooperate with the OECD initiative, their reaction has generally been one of unease with the perceived heavy-handed interference in their limited policy choices. The Bahamas government statement in its 2001 Budget Speech is perhaps a reflection of this uneasiness:

The notion of unfair competition employed in the OECD initiative is a worrisome concept with a clear potential for mischief. It is hoped that the emergence of divergent views within the OECD will cause reflection on this initiative and bring a more focused approach to other concerns of the OECD which have greater legitimacy than ‘harmful tax competition’, and which would elicit greater international cooperation on a voluntary basis.

It is yet to be known how far these OECD measures will impact the appeal of the financial services sector a significant economic policy tool for countries in the CARICOM region. But it is perceived within CARICOM that such measures “will force the Region to once again rethink its development strategy which is currently premised on services, including financial services,

as being areas in which it has a comparative advantage”.<sup>5</sup>

### **3.4. Export-Oriented Technology-Based Industry**

One other sector to which countries in the CARICOM region are devoting increasing attention in the bid to attract increasing investment in order to enhance their export performance is that of technology-based manufacturing or services. This has formed part of the diversification drive designed to reduce their dependence on a single source of revenue.

A prime example of this trend is to be seen in the case of Trinidad and Tobago, where the government is pursuing measures aimed at reducing its dependency on oil and therefore its exposure to international oil price volatility. The government has to this end identified 5 “key drivers” to enable it achieve a diversified globally competitive economy. At the top of the list is the construction of a National Science and Technology Park, which is intended to attract foreign investors in search of an appropriate location to establish “near shore” operations, as well as industries that will produce or use information technology to service the North American market. The project is also intended to contribute to the development of a national system of innovation, through the creation of linkages and relationships in the economy that would permit continuous development, absorption and diffusion of relevant technologies in the society. Activities to be undertaken would include:

- call centres and back office operations;
- software and computer-related services;
- electronic components and accessories;
- computer peripherals;
- telecommunications equipment;
- medical and dental equipment; and
- pharmaceuticals and biotechnology research.

A similar affirmation of an intention to diversify the economy from near total dependence on another resource - tourism - into the development of other services was made by the government of Antigua and Barbuda. The development of informatics-based industries, involving information processing and retrieval, is among the objectives being pursued by the government, through the channelling of resources towards training in these areas.

These policy shifts reveal an awareness in the region that the small size of the domestic market need not be an impediment to the attraction of foreign investment if such investment is made in export-oriented industries. With the shift by TNCs to integrated international production strategies whereby specialised functions are assigned to particular units of the transnational group, an approach such as is illustrated by the examples of Trinidad and Tobago and Antigua and Barbuda appear to offer further possibilities for the attraction of investment into the CARICOM region. Indeed, UNCTAD observes that developing countries with small markets are likely to be more successful in targeting intra-industry activities, particularly component manufacturing. Such integrated international production create “functional niches” for developing countries in areas such as accounting, data processing and the programming of software applications, that could be effectively

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<sup>5</sup> CARICOM, *Caribbean Trade and Investment Report 2000: Dynamic Interface of Regionalism and Globalisation* (Guyana: CARICOM Secretariat, 2000) at 176.

exploited.

Since by their very nature, the products of such activities are destined for export, several countries have established export processing zones to attract such activities. Within these zones various foreign investment restrictions and import rules are waived. In addition, special tax concessions may be offered.

Though the experience of the countries in the CARICOM region so far is hard to evaluate, the experience of other countries have shown that the expected contribution of the production technologies and organization know-how introduced by investors to the upgrading of workers' skills have not materialized. Nor have the technological spillovers expected to arise from linkages between foreign and local industries. This suggests that in resorting to the attraction of FDI into this area in the CARICOM region, attention will have to be paid to these potential limitations and the policy response appropriately shaped to reflect this reality.

### **3.5. Impact of the Creation of a Single Market and Economy (CSME)**

The measures being pursued towards the creation of a CARICOM Single Market and Economy (CSME), involving the convergence in policies and practices of the countries in the region, can reasonably be expected to have a positive impact on the attraction of FDI into the region. The economic literature indicates that regional economic integration may serve to stimulate FDI if various factors are brought about by such integration, including national treatment for foreign investors, effective dispute resolution mechanisms, the existence of strong investor property rights which reduce the risk of direct or indirect expropriation and the creation of a predictable policy environment. Furthermore, regional economic integration could enhance the attraction of a region for investment, for example, through the creation of a wider market which enables firms to grow stronger and larger than is possible in individual national markets.<sup>6</sup>

However, the literature is also clear on the fact that within the integrated region, investment is more likely to be channelled to areas which offer greater locational advantages compared to the others. Such advantages may lie in the abundance of natural resources, the development of industrial sectors and the size of the domestic market.<sup>7</sup>

It has become increasingly clear that the benefits of FDI do not accrue to the host economy merely through attracting increased investment flows, but rather of adopting the appropriate policies that will lead to the channelling of FDI in a manner consistent with a State's development priorities. This observation applies with equal, if not greater relevance, to the countries in the CARICOM region that have recognized the necessity of pooling their resources to enhance their collective competitiveness in a challenging international environment.

Indeed, in terms of contribution to a host State development, FDI inflows may well have a negative impact unless an appropriate policy is pursued by that State. For example, with respect to efficiency, inward FDI may make a positive contribution by, among other things, helping to upgrade domestic

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<sup>6</sup> Blomström, M. and A. Kokko, "Regional Integration and Foreign Direct Investment" *World Bank Policy Research Working Paper No. 172* (April 1997) at 3-7.

<sup>7</sup> *Ibid.*, at 8-9, 20 and 24.

resources and capabilities, together with the productivity of indigenous firms. On the other hand, it could limit the extent to which indigenous resources and capabilities are upgraded by restricting local production to low value-added activities and importing the major proportion of higher value-added intermediate products. Only where an appropriate host country policy is in place (e.g. the assignment of priorities to policies that help upgrade human and technological capabilities) are the efficiency benefits likely to be realized.<sup>8</sup>

Thus as CARICOM continues its efforts in economic policy coordination and convergence of the countries in the region, the challenge will be to ensure that the distribution of FDI within the region is such as to maximize the relative strengths of its member countries in various sectors (particularly those identified above – i.e. tourism, financial services and technology-based industry) for the benefit of the entire region.

Investment attraction into the CARICOM region in the context of the CSME would also require an active and effective organ with the responsibility of not just coordinating the investment policies of the Member States, but also spearheading the search for appropriate policy options that, among other things, will ensure effective targeting of investors to suit the specific locational strengths offered by the countries in the region. The experience with policy coordination and implementation within the region so far appears to leave much to be desired.<sup>9</sup> But the establishment of the CSME has further heightened its importance. It may, indeed, be argued that without it, the idea of a CSME is deprived of much of its essence.

One issue to which attention may have to be given within the context of the CSME is the extent to which tax incentives will be allowed to play a role in the region's determination to attract foreign investment. An earlier attempt was in fact made to harmonise the degree to which CARICOM Member States may grant tax incentives. The resulting document was, however, not implemented by the Member States with the result that over the years, their practices on that issue has diverged from each other. The potential for such divergent practices to have distortionary effects on the CSME warrants a serious examination of the issue. As a prelude to the focus on the CARICOM multilateral tax agreement, the remaining part of this section of the paper is devoted to some general observations on this issue.

Tax incentives reduce the tax burden of entrepreneurs in order to induce them to invest in particular projects or sectors. The more commonly known types of tax incentives include tax holidays, reduced income tax rate, loss carry forwards, investment allowances, investment tax credits, reduced taxes on dividends and interest paid abroad, preferential treatment of long-term capital gains, deductions for qualifying expenses, zero or reduced tariffs, employment-based deductions, tax credits for value addition and tax reductions/credits for foreign hard currency earnings.<sup>10</sup>

Tax incentives are granted for a variety of objectives, including regional development, the promotion of particular sectors (e.g. mining, manufacturing,

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<sup>8</sup> UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development* (Geneva: United Nations, 1999) at 235.

<sup>9</sup> Above note 5.

<sup>10</sup> UNCTAD, *Tax Incentives and Foreign Direct Investment. A Global Survey* (New York and Geneva: UN, 2000) at 4, 11-14.

export or tourism), performance enhancement (e.g. skills training and domestic value added); and the transfer of technology. These objectives may in turn influence the nature of the incentive offered. Thus the promotion of the export industry may be sought to be achieved through, among other things, exemption from import duties on capital goods, equipment or raw materials, parts and inputs related to the production process; exemption from export duties; and income tax credits on net local content in exports. The promotion of technology transfer may be pursued through accelerated depreciation on machinery; income tax reduction or tax holiday; investment and reinvestment allowances; allowances for skills training; and reduction in tax for royalties or dividends.<sup>11</sup>

The general literature leans against the grant of tax incentives as a tool for attracting investment. Among the reasons for this is the fact that since foreign investors have difficulty in knowing how long tax incentives will be preserved, the incentives often attract companies in sectors such as retail trade and the service sector which can easily shift their operations to another jurisdiction with better incentives as soon as the current host country incentives expire.<sup>12</sup> Other problems with the grant of tax incentives include the inability of a host State to target the incentives to its intended beneficiaries; the complexity such incentives introduce into the tax system; their creation of conditions for harmful tax competition among countries; and their susceptibility to lobbying after their introduction, making it difficult to remove them thereafter.<sup>13</sup> Furthermore, the range of tax avoidance strategies available to TNCs may either make the grant of tax incentives largely irrelevant<sup>14</sup> or enable such corporations to unduly exploit such incentives.<sup>15</sup>

Of the types of tax incentives offered by countries, the tax holiday (that is, exemption from taxation, usually for a specified period of time) is considered to be the type most prone to the weaknesses already noted. While a tax holiday does have its advantages,<sup>16</sup> these appear to be outweighed by other disadvantages. For instance, the benefits conferred by such a holiday are thought to be often illusory since it operates only during the years when losses are more likely to be generated by a business venture. It also encourages the formation of new firms, rather than reinvestment in existing ones and may therefore attract short-term investments instead of long-term ones.<sup>17</sup> Furthermore, it creates opportunities for tax avoidance through transfer pricing or cost shifting between holiday-enjoying and non-holiday-enjoying enterprises, not only at the domestic level but also across national

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<sup>11</sup> Ibid at 9.

<sup>12</sup> OECD, *Tax Sparing. A Reconsideration* (Paris: OECD, 1998) at 15.

<sup>13</sup> Ibid, at 29-33.

<sup>14</sup> Holland, D and R Vann, "Income Tax Incentives for Investment" in Thuronyi, V (ed), *Tax Law Design and Drafting*, Vol. 2 (Washington DC: IMF, 1998) 986-1020 at 1012.

<sup>15</sup> OECD, above note 12.

<sup>16</sup> Sewell, D, Tsiopoulos, T and J Mintz, "Effects of Taxation on Investment in Morocco" (1996) 12:8 *Tax Notes International* 573-596 at 591-592. It is thought, for instance, that a tax holiday may involve less administrative cost, and may thus be attractive to firms in that it requires less discretionary action by bureaucrats.

<sup>17</sup> Gersovitz, M, "The Effects of Domestic Taxes on Foreign Private Investment" in Newbury, D and N Stern (eds), *The Theory of Taxation for Developing Countries* (New York: Oxford University Press, 1987) 615-635 at 632.

boundaries.<sup>18</sup>

Although the general grant of tax incentives as a policy has been questioned, it is recognised that in view of the impracticability of recommending their abolition by States which have a strong interest in attracting foreign investment, the grant of such incentives should be permitted but their use as a tool for attracting foreign investment should be rationalised. In this connection, preference is expressed for other types of incentives which are usually granted in combination with or in substitution for tax holidays, including investment tax credits (that is, a mechanism by which a firm is allowed to reduce its overall tax liability by a percentage of the acquisition cost of an asset) and accelerated depreciation (that is, permission to write off an asset at a rate faster than its economic rate of depreciation).<sup>19</sup>

An investment credit or allowance is regarded as having significant advantages over a tax holiday since eligibility for such an incentive is not limited to the early years of the investment. Furthermore, it is thought to have the advantage of being specifically targeted to increased investment with less sacrifice of tax revenue. It also rewards firms for the acquisition of capital, instead of simply rewarding the creation of new firms, as tax holidays do.

In light of these considerations, the variety of tax incentive measures implemented by countries in the CARICOM region will have to be critically reviewed to ensure that they do in fact operate to complement the measures aimed at investment. This will mean revisiting the issue of a common approach to the grant of tax incentives by participating states. Any progress on this front will, of course, depend largely on how far Member countries are willing to accept the loss of fiscal sovereignty for the wider benefit of the region in the context of the CSME.

## **4. The CARICOM Multilateral Tax Agreement**

### **4.1. Background to Agreement**

The multilateral tax agreement was signed on 6 July 1994, to replace the previous multilateral treaty of 1973 and entered into force on 30 November 1994. The 1973 treaty was peculiar in that it was concluded between the governments of the more developed countries in CARICOM (i.e. Barbados, Guyana, Jamaica and Trinidad and Tobago) on one hand and the less-developed ones (i.e. Antigua, Belize, Dominica, Grenada, Montserrat, St. Kitts-Nevis-Anguilla, St. Lucia and St. Vincent). The 1994 agreement makes no such distinction. Like many other tax treaties the avowed objective of the Agreement is to enhance investment and to counter international tax avoidance and evasion.

### **4.2. Notable Features of Agreement**

#### **4.2.1. Source-based taxation**

The treaty is quite unique in attaching greater importance to source-basis taxation than exists in the more widely used treaty model (i.e. the OECD and

<sup>18</sup> Easson, A J, "Tax Incentives for Foreign Direct Investment in Developing Countries" (1992) 9:4 *Australian Tax Forum* 387-439 at 411-412; and Sewell et al, above note 16.

<sup>19</sup> Harberger, A C, "Conclusions and Future Directions for Reform" in Shome, P (ed), *Comprehensive Tax Reform. The Colombian Experience*, IMF Occasional Paper No. 123 (Washington DC: IMF, 1995) at 36.

UN Models). On this score, it has a lot in common with the Andean multilateral convention and is said to have been based on the Andean model.<sup>20</sup> It is thought that the source-basis option was adopted mainly because of its simplicity.<sup>21</sup>

The centrality of the source principle to the Agreement is unmistakable: following immediately after the article defining residence (i.e. Article 4), and before the articles dealing specifically with various types of income, Article 5 states:

Irrespective of the nationality or State of residence of a person, income of whatever nature accruing to or derived by such person shall be taxable only by the Member State in which the income arises, except for the cases specified in this Agreement.

The source principle is re-echoed in the treatment of both active business income and passive/investment income - notably business profits, dividends, interest, royalties and management fees. The normal approach under the OECD and UN Model treaties however, is to accord jurisdiction in respect of active business income to the State of source (i.e. where the permanent establishment is located), but leave primary jurisdiction over investment income to the State of residence, while according the source State residual taxing jurisdiction in respect of such income.

#### **4.2.2. Business Profits**

The concept of permanent establishment is central to the taxation of business profits under virtually all tax treaties and its definition therefore occupies an important place in treaties based on the OECD and UN Models. The concept is defined by reference to activities or facilities that either by their very nature or by reference to a particular time frame are considered to establish a sufficient degree of presence in the host State to permit the exercise of its taxing right in respect of an enterprise's business profits on the basis of source.

The CARICOM Agreement does not use the term "permanent establishment" as such, but its provisions regarding the place where business activities are undertaken (i.e. Art. 8(2)) reflect this concept, with the notable exception that the Agreement includes activities that are not recognized under the Models as amounting to a permanent establishment, for example, a depository, storage facility, warehouse or similar establishment used for receiving or storing goods; and any other premises, office or facilities, the purposes of which are preparatory or auxiliary to the business activities of the enterprise.

#### **4.2.3. Investment Income**

As with the taxation of business profits, the structure of the provisions in the Agreement dealing with the taxation of investment income (i.e. dividends, interest and royalties) generally follows that of the OECD and UN Models. The content also broadly follows the OECD and UN Model approach, with the notable exception that, as already observed, exclusive tax jurisdiction in

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<sup>20</sup> Zagaris, B., "The 1994 CARICOM Double Taxation Agreement. A New Model for Regional Integration and Fiscal Cooperation" (1996) 50:9 *Bulletin for International Fiscal Documentation* at 410.

<sup>21</sup> *Ibid.*

respect of such income is conferred on the source State. However, the taxation of the income in the source State is limited to 15% in the case of both interest and royalties, and 0% in the case of dividend payments.

### **4.3. Potential problems with the Agreement**

The examination in this part of the paper, together with the suggested solutions to the identified problems, draws heavily on observations on the Agreement made by Huub Bierlaagh in an article published in 2000,<sup>22</sup> to which the reader is referred for a more comprehensive critique of the Agreement.

The problems concerning the CARICOM multilateral tax agreement have to do with the striking features of the Agreement that diverge from the well-known models of the OECD and UN, in particular the exclusive taxation by the source State and the conceptual uncertainties that arise from the peculiar manner in which some of the provisions are drafted.

#### **4.3.1. Exclusive Source Jurisdiction**

As already noted, a central feature of the Agreement is the exclusive taxation of active and passive forms of income by the source State. This creates opportunities for tax planning through the shifting of income to low- or no-tax jurisdictions, or jurisdictions with short- or long-term tax incentives in place. It may also work as an incentive for capital export from high(er) taxing countries.

Hence the allocation of resources within the region is likely to be significantly influenced by tax, rather than bona fide business, considerations. Such a situation would undermine any objective of promoting the efficient allocation of resources within CARICOM since member countries with a more generous tax regime than others are likely to be favoured more by investors. Furthermore, the virtually unlimited scope provided for taxing business income in the source State in light of the considerations regarding when a person is regarded as engaged in business activities in a State provides great latitude for the application of domestic laws by the Member States, and with that the prospect of conflicting jurisdictional claims. This will effectively undermine the simplicity thought to have been the objective behind the importance attached to jurisdiction on a source basis.

#### **4.3.2. Conceptual Uncertainties**

Other problems with the Agreement relate to issues regarding which insufficient provision is made or for which the intended effect of the provision is unclear/uncertain. An example that may be cited is the provision regarding the taxation of business profits. Article 8(4) of the Agreement provides:

Where an enterprise carries on business activities in more than one Member State, each State may tax profits from sources within its territory. If the activities are undertaken through representatives, or through the use of facilities such as those indicated in paragraph 1 of this Article, the profits earned shall be attributed to such representatives or facilities provided that such representatives or facilities are totally independent from the business enterprise.

The type of situation being referred to here – i.e. circumstances in which a

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<sup>22</sup> Bierlaagh, H, “The CARICOM Income Tax Agreement for the Avoidance of (Double) Taxation?” (2000) *Bulletin for International Fiscal Documentation* 99-110.

representative or facility is totally independent from the business enterprise appears to be inconsistent with some of the activities or facilities treated in paragraph 1 of the Article as constituting the undertaking of business activity in a Member State, for example, an office or place of management. The question has therefore been raised as to why the proven arms length principle included in the OECD and UN Model treaties was not adopted as the governing rule for determining the allocation of taxing rights.<sup>23</sup>

#### **4.4. Possible Solutions**

There appear to be two main courses of action (a) an amendment of the Agreement to address these shortcomings or (b) changes to the domestic law to nullify potential double taxation or non-taxation or a combination of these two.

It may be thought that to the extent that the problems identified with the Agreement are attributable to the differences in the tax systems of the Member States (e.g. absence of income taxation in some countries), these can largely be addressed by the tax harmonization drive under way in CARICOM. However, such an expectation may be too high and will have to be tempered by the reality of how far the tax harmonization drive will result in the uniformity of tax systems. For example, will a country that levies no income tax agree to begin imposing tax? Conversely, will countries having income taxes agree to abandon these?

It would appear then that effecting changes to the agreement would be more feasible, at least in the short term. While the complete shift to the opposite side of the spectrum of tax jurisdiction allocation by permitting primary residence state taxation of income with a limited source country right to the source state may be too dramatic a reversal of the considerations underlying the Agreement, perhaps a middle ground would be to provide primary taxing right to the source state, while permitting residual taxation in the state of residence. A residual and simultaneous taxing right for the resident state, with an obligation to provide relief from double taxation for that state, would at least reduce the incentive for capital export.

With the view to the removal of these and other potential problems, a comprehensive review may have to be undertaken of each of the Agreement's provisions on the basis of the question as to whether the provision is desirable in view of (a) intra-CARICOM relations and (b) relations between CARICOM and non-Member countries. Regarding (b), for example, it has been argued that the Agreement could be an obstacle to the conclusion of tax treaties with countries outside CARICOM since any taxing right the other country might concede could effectively be rendered void; and that the "coincidence" with a treaty based on the UN or OECD Model creates a wide range of tax planning opportunities since, for example, dividends paid to a CARICOM resident company can be distributed from that country to anywhere in the world tax free.<sup>24</sup>

## **5. Conclusion**

We have observed that countries in the CARICOM region have been able to

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<sup>23</sup> Ibid. at 104.

<sup>24</sup> Id.

attract a significant degree of FDI over the years, although the distribution of such flows has varied from country to country. However, there still appears to be room for increased FDI flows, particularly into sectors where the region enjoys some comparative strengths, especially in the area of services. These could be further enhanced with the creation of a CSME but this will require an active and targeted regionally designed investment policy.

The possibilities and problems identified in this paper are not unknown to policymakers in the region. The need to adapt their economic policy priorities to enable them deal effectively with the challenging realities of the modern environment is widely recognized throughout the region and measures have been, or are being undertaken, to that end. These measures will have to be intensified if the expected benefits from greater integration among the countries in the region are to be realized.

Regarding the CARICOM double taxation agreement, it has been seen that the exclusive source taxation principle on which it is based could give rise to problems in terms of intra-community capital flows, as well as capital flows from outside CARICOM. This, along with other apparent defects in the Agreement may detract from the objectives for which it was concluded, and the appropriate solution appears to lie in a revision of the Agreement in a manner which does not necessarily undermine these objectives.

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