Assessment and recommendations

The Dominican Republic, though the fastest-growing economy in Latin America and the Caribbean since 2010, cannot afford complacency. The COVID-19 crisis may accelerate existing global trends that created the need for reforms addressing structural weaknesses that lurked beneath the surface well before the pandemic. The current situation demands an unprecedented policy effort to ensure a prompt and effective health response, and to guarantee short-term support for workers and firms. The enduring challenge will be updating the country's development model through targeted reforms. Specifically, the Dominican Republic needs to pursue three goals: 1) Strengthening its governance capacity to anticipate and adapt to change; 2) Diversifying its trade and investment base and increasing regional economic ties; and 3) Boosting innovation by filling institutional gaps and mobilising long-term financing.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

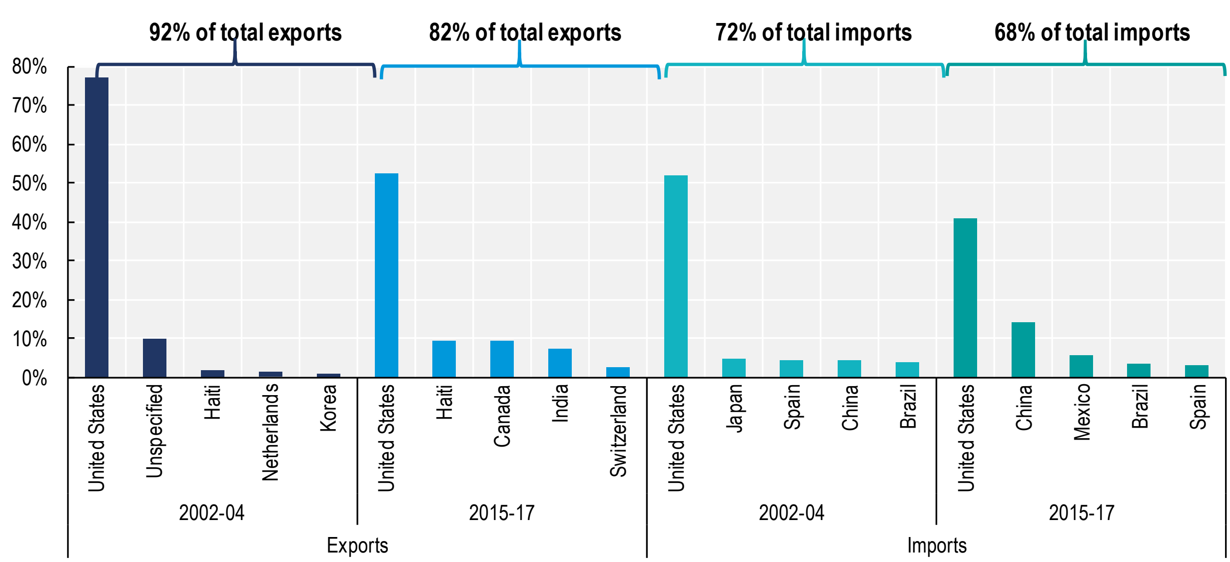
The Dominican Republic has made notable strides over the past two decades in diversifying its trade and investment base. However, it lacks a base that is diverse and innovative enough to create resilience to external shocks, whether those shocks relate to economic – or public health – conditions

The country can look back on 20 years of progress from being a relatively isolated island economy to one integrated into global developments and trends, a change that is mostly a blessing but – as the current pandemic demonstrates – can also be a curse. How the Dominican Republican can continue to benefit from the good, while warding off the bad should be a central matter of concern for policy makers in the coming years.

From 98 different trading partners in 2000, the Dominican Republic expanded to include 147 by 2017, a solid feat. Equally importantly, the United States went from taking up 75% of Dominican exports to slightly more than 50% (Figure 0.1). It simultaneously deepened the relationship and lessened its dependence on its mighty neighbour in the north. The Dominican Republic has also expanded its investment network by receiving investment in new industries, such as medical devices, and by formalising a diplomatic relationship with the People's Republic of China (hereafter "China") in 2019, opening up new possibilities. Other new investors have also started to emerge in the last decade, notably Brazil and Turkey.

Figure 0.1. Dominican Republic's top 5 trading partners, 2002-04 and 2015-17

Share of total gross merchandise exports and imports



Source: Authors' elaboration based on UN Comtrade database, 2019 https://comtrade.un.org/.

The United States remains the main investor in the country, accounting for 23% of total FDI in the economy, but its relevance is 5% less than in 2010-14. Three sectors account for 95% of all FDI from the United States: manufacturing is the first, accounting for 65% of the FDI from the United States, followed by customer and market services (20%) and business services (10%). This pattern shows a stark difference with neighbouring Costa Rica, a somewhat comparable economy that since the 2000s has focused on attracting knowledge-intensive FDI. In fact, manufacturing accounts for 31% of all FDI from the United States, followed by customer and market services (15%), and R&D (13%). The top three sectors account for 65% of FDI from the United States, a full 35 percentage points less than the Dominican Republic. Furthermore, the Dominican Republic captures only 0.8% of the total investment flows within Latin America and the Caribbean while Costa Rica reaches 4.6%.

Tourism has come to play a vital role in the economy. From 2000 to 2018 the number of tourists more than doubled from 3.3 to 7.2 million. The country is now the main destination for tourism in the Caribbean, attracting 24.1% of the total number of visitors in 2018, and the fourth most popular destination in Latin America, after Argentina, Brazil and Chile. But the industry poses challenges with regards to energy, water use and waste management. And the COVID-19 pandemic has created an urgent need to cushion the short and medium-term impact on the sector.

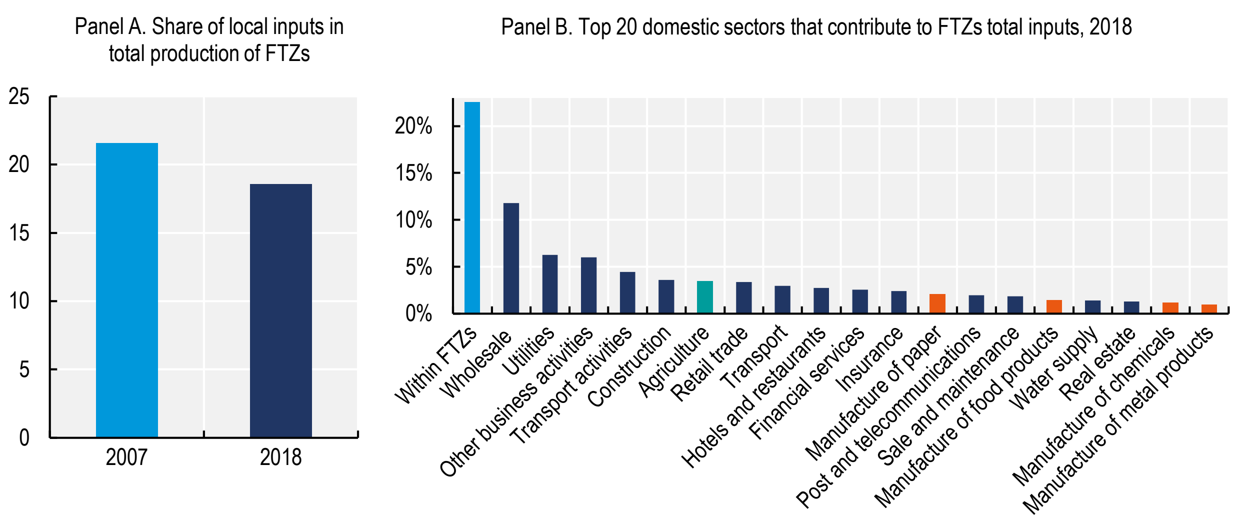
The country's Free Trade Zones (FTZs) have changed in nature, after having been established in the late 1960s mostly to attract assembly operations in textiles and garment and electronics. From 1995 to 2017, the share of exports from FTZs on total exports decreased from 80% to 56% from 1995 to 2017. The expiration of the multilateral system of apparel quotes radically altered the global trade conditions in the sector, inducing a reconfiguration of Dominican FTZs towards services and other activities.

Economies that have benefited from globalisation have common traits that the Dominican Republic could emulate. Reducing dependency on a single market, managing complex trade networks, strengthening regional ties, and branding themselves as reliable, high-quality trade and manufacturing partners, are some of those characteristics.

The Dominican Republic has a small trade network, loosely connected to regional value chains when compared with, for example, Singapore. Only 8 countries account for over 1% of total intermediate exports from the Dominican Republic, versus 18 for Singapore. Moreover, while Singapore is highly connected to regional partners, the Dominican Republic imports mostly from the United States and to lesser extent from China, and exports predominantly to the United States. In contrast, Singapore can reap the benefits of the dense value chains that have developed in Asia.

FTZs have not yet become a driver of local development and, on average, local sourcing has declined. Firms operating in garment and textiles source 28% of their inputs locally, and new industries tend to rely less on local providers (Figure 0.2). Between 2005 and 2018, the share of inputs sourced locally by firms located in FTZs decreased from 22% to 18%. In the case of some of the newly installed activities in the FTZs, such as medical devices, there is no ready-made local industrial base from which to source, as the industry is new. In fact, the firms operating in the FTZs in medical devices, source only 3% of their inputs locally.

Figure 0.2. What are firms in the FTZs sourcing locally in the Dominican Republic?



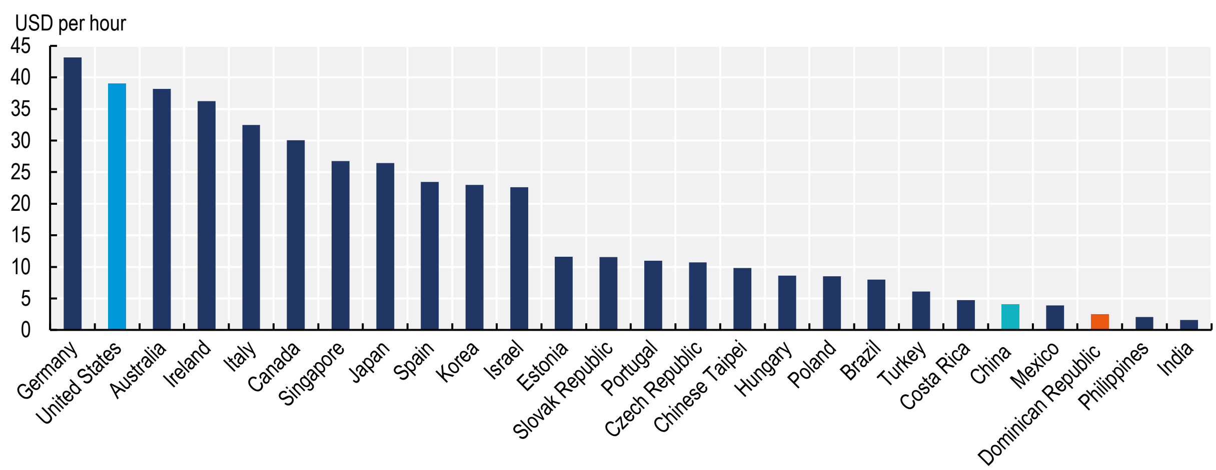
Source: Authors' elaboration based on General Directorate for Taxes DGII http://www.dgii.gov.do/ and Dominican Republic Central Bank, 2019 https://www.bancentral.gov.do/.

The Dominican Republic's export profile shifted from labour-intensive manufacturing to primary commodities. These nowadays account for 43% of domestic exports and the main items include gold, tobacco and fruits and vegetables. The end of the garment trade framework and the start of new mining projects explain the shift. A partnership pact between the European Union and CARIFORUM, signed in 2008, raised agricultural exports by more than 20% between 2013 and 2017, with Germany, the United Kingdom, France and Italy as main importers.

Dominican labour costs are competitive at a time when labour costs are not determinant of firm decisions on where to locate. Labour costs in the Dominican Republic are 6% of those in the United States and are lower than in China (Figure 0.3). Markets would wide increasingly value sustainability and social inclusiveness and accountability on these fronts. In addition, countries are increasing their attention towards the need to rebuild domestic manufacturing capabilities in their economies, a trend which was present before COVID-19 and which the current economic crisis is magnifying.

Figure 0.3. Labour costs in the Dominican Republic are 6% of those in the United States

Hourly labour cost in manufacturing, the Dominican Republic and selected countries 2018 or last available year

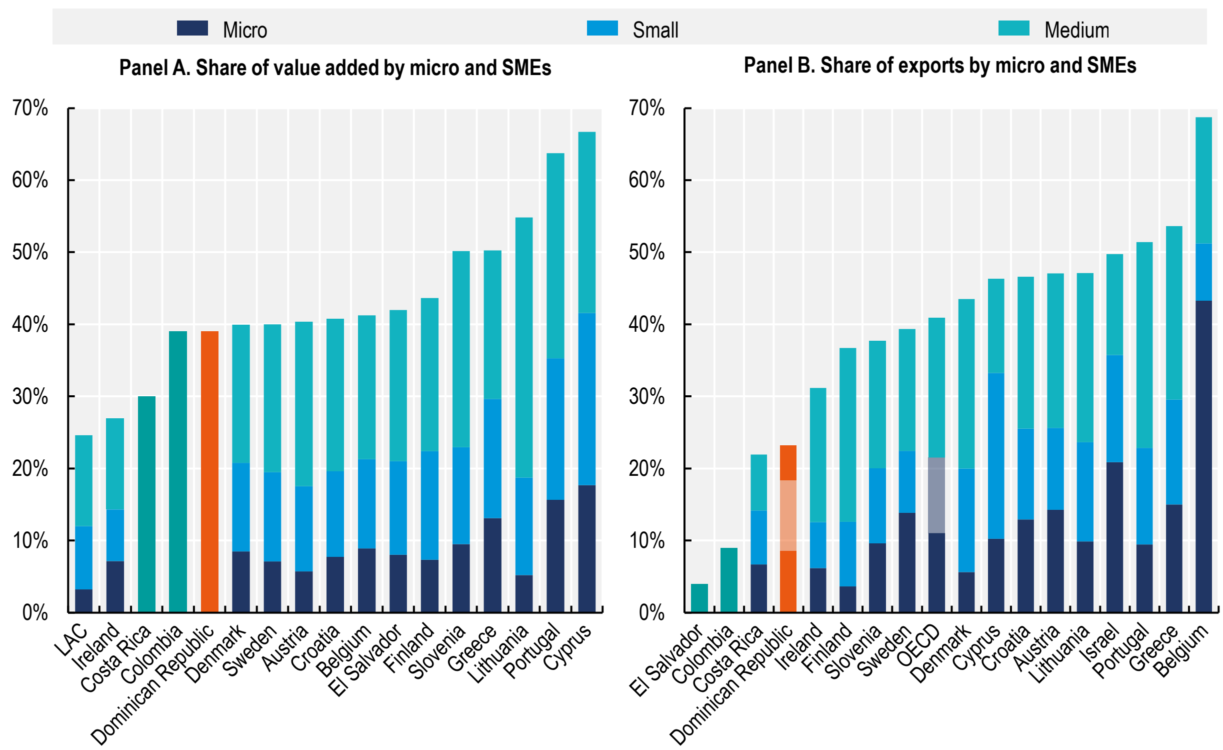


Note: Labour cost includes direct pay, social insurance expenditures, and labour-related taxes. Costa Rica (2018); Dominican Republic (2017); China (2013); India (2014); all other countries (2016).
Source: Authors' elaboration based on Conference Board International Comparisons of Hourly Compensation Costs in Manufacturing, https://www.conference-board.org/, Dominican Republic National Survey of Economic Activity (ENAE), https://www.one.gob.do/encuestas/enae and Costa Rica National enterprises survey http://www.inec.go.cr/, 2019.

Small companies have unexploited potential to drive growth in the Dominican Republic. Micro, small and medium-sized firms are less export-oriented than their peers in OECD countries. These firms employ 65% of the total workforce, contribute to 40% of total value-added and account for 23% of domestic exports (Figure 0.4). In OECD countries, these firms account for 40% of total exports. And in the Dominican Republic of these firms the majority are micro, which increases their fragility and vulnerability to crises.

Figure 0.4. MSMEs contribute only 23% to national exports, while in OECD they account for 40%

Dominican Republic and selected economies, 2018 or last available year



Note: The figure takes into account only enterprises in business activities ISIC rev. 4 (div 5-82). The OECD definition of size class: micro (1-9 persons employed), small (10-49 persons employed), medium (50-249 persons employed). Size class classifications in the Dominican Republic are defined according to the parameters contained in Law 187 of 2017. This involves two different indicators, size and turnover, with three different thresholds: micro (1-10 persons employed and DOP 8 million), small (11-50 persons employed and DOP 54 million), and medium (41-150 employed and DOP 202 million).

Note by Turkey: The information in this document with reference to "Cyprus" relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".

Note by all the European Union Member States of the OECD and the European Union:

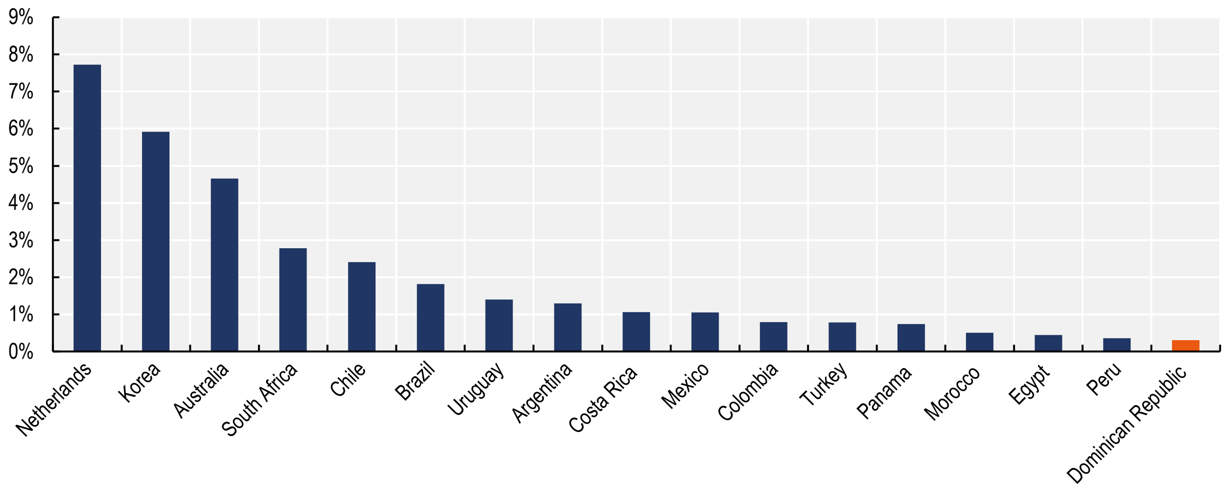
The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

Source: Authors' elaboration based on OECD Structural and Demographic Business Statistics (SDBS), https://stats.oecd.org/, Dominican Republic General Directorate of Internal Taxes DGII https://dgii.gov.do/ and ECLAC (2018), Mipymes en América Latina: un frágil desempeño y nuevos desafíos para las políticas de fomento, repositorio.cepal.org/handle/11362/44148.

Innovation is a weakness in the Dominican Republic, even at regional standards. The most recent available estimates reported an investment in R&D of 0.01% of GDP in 2015, below the already very low Latin America and Caribbean average of 0.7% for the same year. The innovation gap is particularly severe when looking at one of the most important economic sector: agro-food. The investment in agro-related R&D as a share of agricultural value-added in the Dominican Republic is 0.19%, in 2018, below other agro-food exporters Chile (2.41%), Brazil (1.82%), and Costa Rica (1.1%) (Figure 0.5).

Figure 0.5. The Dominican Republic invests little in agro-food research

Agricultural R&D expenditure by government, non-profit and higher education agencies as a share of agricultural value-added, 2018 or latest available year



Note: R&D: Research and development. 2017: South Africa; 2016: Korea, Chile; 2015: Netherlands, Turkey, Morocco; 2014: Uruguay, Colombia, Egypt; 2013: Australia, Brazil, Argentina, Costa Rica, Mexico, Peru; 2018: Dominican Republic.
Source: Authors' analysis based on OECD Science and Technology Statistics database, 2019 http://stats.oecd.org/ and ASTI Agricultural Science and Technology Indicators database, 2019 www.asti.cgiar.org/data.

> *The COVID-19 pandemic is accelerating some pre-pandemic trends and it is increasing uncertainty exponentially, offering few sure bets for future prosperity. To thrive, countries need to increase their capacity to anticipate and adapt, knowing that at the moment we know very little about what the post-pandemic world will look like.*

Localisation strategies were in flux even before the pandemic. Relocation was happening, but was not a major trend. As recorded by FDi Markets, the number of relocation projects increased from 22 in 2013 to 160 in 2018 (representing 1.3% of total FDI projects in the period). Most of global relocations happened within the United States (12%) and from the United States to Mexico (11%), followed by China to Mexico (5%) and Germany to Poland (3%). Most of these relocations concerned activities in automotive components, industrial equipment and food. The current pandemic is putting global economies under strain; one dimension has been the disruption in global value chains. Suddenly, it has become very difficult to operate globally and to manage and control suppliers dispersed around the globe. With most economies under full or partial lockdown and with trade and investment contracting, the future of FDI is more uncertain than in the pre-COVID-19 situation.

The agro-food industry, a mainstay of the Dominican Republic's economy, now faces unprecedented challenges and opportunities. COVID-19 is an immediate issue. However, alongside it, the industry and its stakeholders must grapple with changing demands, as consumers are reorienting choices, with new safety measures in the workplace for small farmers and logistics operators, and with challenges in importing and exporting. Value chains will tend to be shorter, the use of digital technologies for traceability and transparency will increase, and firms will face growing domestic demand as they tap into regional markets. Increasing innovation capacity, improving country branding and enabling small farmers to navigate change through modernised extension services will remain key to success.

> *The Dominican Republic is facing this globally uncertain and fast-changing situation by implementing policies to address the health emergency and to limit the economic consequences of the crisis. In parallel, the country needs to update its long-term development agenda juggling with a highly uncertain economic landscape.*

The Dominican Republic has acted fast, as other countries in Latin America, to limit contagion. But the economic consequences of COVID-19 could be particularly severe due to the characteristics of the economy: tourism is among the most hit industries, even though the country has shown in the past a strong capacity to rebound after environmental shocks. Remittances, which account for 7% of GDP and mostly come from the diaspora in the United States are likely to be severely affected. The large number of micro-firms and extensive informal sector also make the country highly vulnerable. On the other hand, the limited insertion of the country in global value chains and the relevance of the domestic market and the public sector in sustaining the economy could help to cushion the adverse impact.

As part of the national development vision for 2030, the Dominican Republic has implemented reforms that offer the potential for a new growth model. A digital agenda started in 2019 with a budget of USD 133 million, of which 93% is devoted to fast-tracking the use of digital technologies in schools, and the rest offers financing digitalisation in firms. A new online platform now operates as a one-stop shop for the administrative procedures required to start a business, under the auspices of the National Competitiveness Council. The national quality infrastructure system has also improved.

The policy mix in the Dominican Republic leans heavily on indirect financial support in the form of special fiscal regimes. While this has well served the economy to attract investment and foster over time the development of new activities in the economy, including recently the creative industries, the policy mix would require an update to unleash the local entrepreneurial potential and foster innovation. The total budget for economic transformation including the special fiscal regimes was around 2.9% of GDP (USD 2.4 billion). However, the quite high budget of the Dominican Republic disguises a policy mix that is unbalanced towards tax exemptions and special economic regimes. While the country has definitely made progress, this mix falls short the unprecedented challenges and would require an update to sustain preserving growth and achieving resilience in the medium- and long-term.

To go forward, three themes should be at the core of the future policy agenda:

1. **Strengthening the capacity to anticipate and adapt**

In moments of high uncertainty and multiple challenges, planning is crucial. Planning involves not only the decision on what to do and how to do it. Planning is also strategic and forward-looking thinking, matched with consensus-building. It is increasingly linked to the capacity to identify possible outcomes, clarify what is desirable and what is risky, and having back-up plans to act in case of sudden and unexpected changes. A dedicated unit needs to be in charge. National leadership needs to value prospective work and needs to ensure co-ordination and consultation across stakeholders. The ongoing crisis has also shown that even good is not enough. Governments need to communicate their vision effectively, maintain an open dialogue with citizens and stimulate individual responses in line with collective interest. Though there is no single solution to the leadership problem, someone needs to be in charge and accountable for scenarios and foresight.

The Dominican Republic has a Ministry of Planning with a mandate to develop long-term national strategies. In going forward, the country should increase its capacity to plan and define future scenarios. The country also needs a better mechanism to update scenarios and transform them into policy guidance. Demanding prospective analysis and tasking a team to do that are only preliminary steps. It is important to define a mechanism through which these prospective analyses feed the process of strategy definition and policy implementation. Co-ordination with all ministries and agencies and at all levels of government is needed. To make scenarios relevant in public policy, leaders must include elements of scenarios and foresight in the overall training for government officials.

Strengthening planning would also require shifting towards a place-based approach to policy-making. Apart from the special economic regimes for firms operating at the border zone with Haiti, the country lacks a place-based approach. Integrating regional and territorial development in the planning process is a fundamental priority for the country to update its economic model and make it more inclusive and sustainable. Identifying how to address regional and territorial development issues in national strategies, also by clarifying the associated financing mechanisms, will be key in delivering results to all citizens and identifying new sources of growth.

2. **Diversifying the trade and investment base and increasing regional ties**

While there are multiple bodies that deal with FDI in the Dominican Republic, fully empowering one agency would be critical step forward. Existing institutions, as the Centre for export promotion and investment attraction, could perform this function if properly modernised and reformed. The agency in charge needs to be able to operate quickly and have timely access to decision-making and needs a pro-business and private sector-oriented staff. In addition, the country would need to align the FDI policy with the national development strategy by complementing incentive packages with targeted tools to foster local industrial development. When foreign firms set up operations in FTZs, they rarely develop local linkages if that was not envisaged in the first place. The experience from Asia, Latin America and more recently Africa, shows that it is possible to develop local linkages and to require investors to source locally. But this benefit comes about through a process that often requires government support to bridge several gaps:

- The operational gap, as the foreign firm normally has an already established network of suppliers and might not even be aware of local possibilities.
- The information gap, as the foreign firm does not know rules and forms of operation in the local economy.
- The trust gap, as starting to work with new suppliers requires developing mutual understanding and trust, which requires time that often businesses are not ready to invest.

In this context, the country should give priority to the following set of actions:

- Fostering learning from FDI and multinationals. The country would also benefit from actively fostering learning spillovers from investors and FDI. The existing experience of Cybernetic Park provides an interesting example that could be replicated. Shifting to a more proactive approach in FDI attraction would enable the Dominican Republic to better negotiate which type of investment and which conditionalities could best serve the interest of both the investing company and the local economy. Spillovers could also increase resilience if investors decide to relocate for some reasons, as domestic learning and capabilities would stay in the economy.
- Continue expanding and updating technical co-operation with traditional partners. The country has well-established partnerships for development co-operation in the areas of production development, mostly with the United States and Europe. In a highly uncertain global environment, renewed efforts to identify new forms of co-operation and partnerships with traditional partners are crucial.

- Learning to co-operate with new partners. The Dominican Republic needs to develop and effectively manage relations with emerging and potential prospect partners. Strengthening ties with Latin America and the Caribbean is a major priority. The recently established diplomatic relationship with China requires strengthening economic diplomacy and sophisticated efforts to define a national strategy.

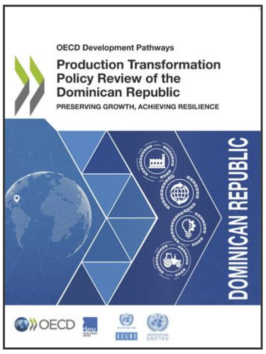
3. **Boosting local industrial development and innovation by filling institutional gaps and mobilising long-term financing.**

Over the decades, the country has developed an economic model based on granting special fiscal regimes to areas of priority and peculiar interest, including manufacturing, tourism and creative industries. While this approach has enabled the development of new activities in the economy, the country would benefit from an updated approach to achieve the national vision of inclusive and sustainable development:

- **Filling the institutional and funding gap for innovation.** While there is a generalised consensus that innovation matters for development, the country falls short in terms of institutions, funding mechanisms, and overall policy mix to foster start-up development and innovation. The country needs to invest in innovation and in parallel needs a targeted body in charge of implementing the innovation policy. The agency should be agile, small and with a clear assigned budget. Ideally, innovation funding should be multi-year and the processes for funding disbursement should be fast and transparent. The ongoing project of the statistical office to design an innovation survey that documents efforts in this sphere is a positive step.
- **Ensuring long-term financing.** The country does not have a development bank that plays this role. There are some institutions that the Dominican Republic could leverage. Banca Solidaria was established in 2012 as the second-tier bank for MSMEs and on Bandex. Bandex is the national export development bank, set up in 2015 as a result of the restructuring of the National Housing and Production Bank (BNV). Bandex could be scaled up to assume the function of financing production development and innovation, including exports, therefore filling the gap in the current financing chain the country. This, however, would require careful due diligence and institutional design and a clear clarification of the division of labour with existing commercial banks.

The outlook for trade and investment is highly uncertain, and the Dominican Republic must prepare for a world in which resilience will be critical. Diversifying economically, innovating, and better sharing the gains of growth is not easy. Every country has competing visions and aspirations, a unique historical trajectory, and an institutional legacy that shapes how it defines strategies and implement policies. But a common trait of successful transformation strategies is high-level leadership to foster business development in new activities. Learning how to perform new tasks and run successful businesses, trading and innovating require work on multiple fronts, including infrastructure building, fiscal reforms, and incentives targeted to firms. It also requires reconciling interests of actors that respond to different incentives, including the scientific community, local firms, and multi-national companies.

A committed government and a private business community willing to invest and take risks are essential to success. The Dominican Republic can capitalise on the accumulated past growth gains, its proven capacity to adapt to global changes to achieve a renewed pact between government, firms and the society to achieve a more inclusive growth pattern. A national vision and a concerted strategy with Latin America and the Caribbean will also be crucial elements in solving the development riddle during and after the current global health and economic crisis.



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