This document contains the conclusions of the IMF mission that visited Aruba during January 12-19. We would like to thank the authorities and other participants at our meetings for their cooperation. The warm hospitality extended to the mission is also appreciated.

The hard work of Aruban people, strong public institutions, stability-oriented macroeconomic policies, and a well-chosen development strategy have made Aruba a developed service economy. Following a deep crisis sparked by the closing down of the Lago oil refinery in 1985, Aruba has built a competitive tourism industry, revitalized the oil refinery, and developed a sizable service sector. Uninterrupted growth until 2000 helped the country to reach one of the highest income levels in the region. Openness to foreign investment, a liberal trade policy, and a responsible local business community were also key to the success. Rapid growth and development attracted large inflows of immigrants who greatly contributed to and shared the results of Aruba’s success. Social cohesion and tolerance were important building blocks of economic development cemented by a modern social support system, including universal health care and state pension.

The recession in 2001-02 combined with a rapid increase in public sector employment and an ill-designed health care reform, however, set off an unfavorable fiscal trend. While the economy is pulling out of its first postautonomy recession, the fiscal stance has remained loose. Central government deficit including AZV rose to an estimated 5½ percent of GDP in 2004 and central government debt including AZV reached an estimated 45.9 percent of GDP, up from 28½ percent in 2000. With unchanged policies, public debt will continue to rise rapidly, which will endanger economic stability.

Wide-ranging policy and institutional reforms are needed to meet the challenges of the 21st century and secure prosperity. The key tasks are to consolidate public finances in the medium term, to find a new strategy both to enhance the long-term growth potential of the country and to address the problems of rapid population aging, and to improve the quality of public institutions.

I. Short-term outlook and the macroeconomic policy mix

With a strong rebound in tourism and vibrant private investment, the short-term economic outlook is favorable. The mission projects growth of 3¾ percent in 2005, following an estimated growth of 3½ percent in 2004. Investment is expected to remain
the engine of growth, supported by robust private consumption and a strong growth in the tourism sector.

**The favorable cyclical position provides a good opportunity for the government to rein in fiscal deficit.** Without additional measures, the mission projects the central government deficit (excluding AZV) at about 4½ percent of GDP in 2005, well above the target in the budget, and the deficit of the AZV at 1 percent of GDP. The higher projected deficit of the central government is mostly attributable to overly optimistic revenue projections. This outcome would result in further fiscal expansion and a continued rapid increase in government debt. The mission projects the central government debt, including the debt of AZV, to grow to about 48½ percent of GDP in 2005. With a strong economy, a fiscal stimulus is not only unnecessary, but it is also detrimental, because it keeps the non-oil current account deficit wide and generates inflationary pressures. The mission recommends taking measures to meet the original budget deficit target of 1.9 percent of GDP in 2005. This would appropriately tighten the fiscal stance and, thus, reduce the need for the central bank to keep monetary conditions tight. Additional measures should concentrate on curtailing expenditure on purchased goods and services, wages and health care.

**The monetary stance is appropriately tight, and, with a gradually narrowing output gap, it should not be loosened before a tighter fiscal stance has been firmly established.** The mission projects a year-average inflation rate of 2½ percent in 2005, broadly unchanged from 2004. Given a favorable inflation outlook and a considerable narrowing of the part of the current account deficit of the non-oil sector which is not financed by foreign direct investment, the mission sees no immediate need for further monetary tightening. Nonetheless, the CBA should closely follow inflation and current account trends and stand ready to tighten the monetary policy stance if the need arises, in particular if the fiscal stance is further loosened. Although the reintroduction of credit ceilings seems to have been a success, the mission recommends an increasing reliance on market-based monetary policy instruments in the future.

**Aruba has preserved its competitiveness and the peg to the U.S. dollar remains appropriate, but international reserves need to be strengthened to increase Aruba’s capacity to withstand external shocks.** A strong rebound in tourism, also helped by the weak dollar, and large planned investments in the tourism sector and the oil refinery suggest that the exchange rate has remained at a competitive level. Wage discipline and restructuring in the private sector during the recession positioned well the private sector to fully benefit from the recovery. While still broadly adequate, the international reserve position has somewhat weakened since 2002. Given Aruba’s vulnerability to external shocks, the rapid increase in public external debt since 2000, and the contingent liabilities of the government, reserves should be increased to fully reverse the erosion. The recommended fiscal consolidation, together with some additional external public borrowing in 2005, would achieve this without injecting excess liquidity into the economy.
II. Developing a New Medium-term Fiscal Framework

Without fiscal reforms, public debt will continue to increase rapidly and reach over 60 percent of GDP by 2009, which would be a dangerous territory for Aruba. Fiscal policy in the medium-term needs to be geared towards arresting this alarming trend and reducing public debt to a safe level. The mission, therefore, has recommended to the government a medium-term fiscal path that would reduce public debt to 40 percent by 2009. This path involves a sizable reduction in non-interest current expenditure, also to allow for reallocating resources to public investment and education.

Aruba needs a smaller and less expensive civil service. A close to 10 percent increase in the civil service between 2001 and 2003—partly attributable to granting 13 days of additional annual leave to civil servants—has not only increased the government payroll, but it has also made future fiscal consolidation more difficult and put pressure on the labor market. Moreover, salaries in the public administration are close to 40 percent higher than in the private sector. These trends, combined with a minimum wage which is about 37 percent of the average wage in the private sector, will generate wage pressures in the economy and may hurt Aruba’s competitiveness in the medium run.

A medium-term fiscal framework together with a fiscal responsibility act would promote fiscal consolidation and enhance the transparency and credibility of macroeconomic policies. As a first step, an expenditure policy review is recommended to set new budget priorities and identify wasteful expenditure. Based on this, the government could set rolling three-to-five-year nominal ceilings on main expenditure categories—underpinned by a set of well-identified fiscal reforms, such as, for example, civil service, health care and pension reforms—to ensure an orderly fiscal consolidation. A fiscal responsibility act, stipulating a transparent and flexible fiscal rule, would further enhance the credibility of a new fiscal framework by creating the right incentives for disciplined fiscal policies. The mission is convinced that Aruba would greatly benefit from introducing such fiscal framework at this juncture.

The recent reforms in the management of the health care system are encouraging, but more needs to be done to solve the problems AZV faces. The sharp increase in health care costs after the creation of AZV was in large part attributable to design flaws which created incentives for family doctors to refer patients to specialists and loosened control over the costs of health services delivered by specialists. The benchmarking of family doctors seems to have been an effective measure to reduce expenditure on prescription drugs, laboratory test, and referrals to specialists. The establishment of a positive list has further reduced the pressure on the budget for prescription drugs. Further efforts are needed, however, to reduce the markup on imported drugs and to ensure that specialists keep costs within their negotiated budgets. Moreover, measures to rationalize demand for health care services, in particular a co-payment system, need to be introduced.
Further tax reforms are needed to broaden the tax base, reduce the tax wedge on labor, and simplify taxes. The introduction of a broad-based consumption tax, also recommended by previous IMF missions, is key to achieving these goals. A simplification of the personal income tax regime, including a reduction of the number of tax brackets and the elimination of all tax exemptions and deductions other than the child tax credit, would greatly enhance the efficiency of this tax and reduce the burden on the tax administration. A lower marginal rate for high-income tax payers would also make Aruba a more desirable location for skilled people and, thereby, facilitate the development of high-value added service industries. The outdated import tariff structure— which hinders the required upgrading of hotels and puts unnecessary burden on the customs administration—also needs to be simplified.

We welcome the government’s recent attempt to create a more client and service oriented tax administration. A successful implementation of the restructuring of the Tax Department is expected to improve tax services and, through this, the efficiency of tax collection. We encourage the Tax Department to set up focus groups of different types of tax payers to monitor the implementation and assess the results of the restructuring. A simplification of the personal income tax and the import tariff structure would make the advantages of this restructuring even more apparent to tax payers. Moreover, further efforts are needed to improve the information sharing with SVB to strengthen the efficiency of the collection of pension contributions.

Recent measures have significantly reduced previously accumulated expenditure arrears of the central government budget. Looking forward, it is important to gear cash and debt managements towards securing the necessary funds for the budget to meet its financial obligations on time, including contributions to APFA.

III. The Future of Aruba

Unless labor productivity growth increases significantly, the pace of economic growth will sharply decline in the long run and the pressure on the budget will mount. The rapid growth of the 1990s was highly labor intensive and relied on a continuous inflow of immigrant labor. Labor productivity growth remained below 1 percent a year in the 1990s, which is considerably lower than in countries with similar income levels. This strategy, however, is not viable in the long run because population density is already rather high and a new wave of large immigration would create severe economic and social problems. Therefore, the rate of labor productivity growth needs to be increased to maintain Aruba’s long-term growth potential at a sufficiently high level. This will require a gradual shift towards higher value-added economic activities. According to our calculations, if net immigration is reduced to zero and labor productivity growth remains unchanged, economic growth will drop to below ½ percent by 2020 as population aging accelerates.

One of the biggest challenges for the government is to create the conditions for a stronger labor productivity growth and diversification into high value added services. This will in the first place require a more skilled labor force. While Aruba has made considerable progress with improving and extending public education, its labor
force is still considerably less skilled than in countries with similar income levels. Renewed efforts will therefore be needed to improve public education, including adult education and retraining of unemployed. The representatives of the private sector we met expressed interest in forming private-public partnerships for retraining their employees to enable them to provide new, higher quality services, for example in conference tourism. Public infrastructure will also have to be improved and the regulatory and tax environment will have to be made more conducive to the required structural changes.

**Policies to maintain adequate labor supply and high labor utilization will also be essential.** At present labor utilization in Aruba is significantly higher than in most developed countries. To maintain this in the face of an expansion of enrollment in higher education and a natural trend to prefer leisure over work at higher income levels, incentives need to be created for old-age people to continue working. Pension reform, in particular measures that result in an increase in effective retirement age, is of vital importance in this regard. The recommended streamlining of the public sector would also release skilled labor to the private sector, thereby increasing aggregate labor productivity.

**Pension reform is also essential to reduce the fiscal burden of population aging.** Given the large share of public sector employment, the interactions between pension schemes, and the political economy of pension reforms, the public sector (APFA) and the universal (AOV) pension schemes should be reformed in a coordinated manner. The most important measure to be taken is to increase the effective retirement age to bring it in line with increased life expectancy. Setting the proper incentives to participate, also by making the schemes actuarially fair, is also an important step that needs to be taken. The recent reform of the public sector pension scheme for new participants was an important step in this direction. It is, however, equally important to reach an agreement with the trade unions on the reform of the rules for the old members of APFA. This would allow APFA to fully comply with prudential regulations and to be supervised by CBA. The vulnerability of the economy to external shocks and the expected rapid population aging seem to justify a large funded component also in the universal pension system, which is at present a pay-as-you go system. Moreover, the regulatory and tax environment should be conducive to higher private pension savings. Risk diversification will require a continuous increase in the share of pension assets invested abroad. This and an increase in the number and size of pension funds will require continued strong effort on the part of the CBA to maintain high quality supervision.

**While Aruba has made considerable progress with alleviating poverty, available data suggest that income inequality is still considerably larger than in countries with comparable income levels.** Further research is needed to design policies that would lift the most disadvantaged groups out of poverty without creating disincentives to work and putting excessive burden on the budget.

**The cost of postponing reforms is prohibitive.** The mission’s calculations suggest that with unchanged labor productivity trends and pension rules, aging related costs for the budget would escalate soon after net immigration is halted. Without reforms, public
debt would reach over 250 percent of GDP by 2030 under such assumptions, which is clearly unsustainable. The size of the long-term fiscal problem is one of the most compelling arguments in favor of highly disciplined fiscal policies in the coming years.

IV. Improving the quality of public institutions

Reforms are needed to improve the efficiency of public companies. The incorporation of SETAR was an important step in this direction, which should be followed by the privatization of public sector utility and telecommunication companies. Moreover, wherever it is possible, competitive pressure on public companies should be increased by opening up these sectors to private companies. International experience suggests that competition and privatization can lead to major efficiency improvement in these sectors. Recent developments in the mobile phone industry in Aruba attest to this general finding. Competitive pressure and privatization, combined with proper regulation, would also restore wage discipline in these sectors.

We encourage the government to initiate a review of the central bank law with a view to adopt the best practices on central bank independence. Best practices on central bank legislation define the term of the governor, strictly limit the reasons for dismissal, exclude government officials from the central bank’s policymaking bodies, and prohibit direct financing of the government. These are among the areas where Aruba’s Central Bank Ordinance could be strengthened.

The government should reinvigorate its efforts to improve statistics. A continuous separation of experts has forced the Central Bureau of Statistics to abandon its attempt to produce proper price deflators and endangered the compilation of the national accounts at current prices. We encourage the authorities to seek technical assistance and external training for the staff at CBS to strengthen national accounts, government finance, and labor market statistics, and to reallocate sufficient funds to CBS to conduct regular labor market and family budget surveys. The latter would also allow the CBS to compile a data base for a core set of social indicators to support research on poverty and social policy formulation.

V. Financial Sector

The banking sector has weathered the recession well and seems well-capitalized and highly profitable. The share of nonperforming loans seems to have been brought under control and the acquisition of Interbank Aruba by Aruba Bank in late 2003 has further strengthened the banking system. The lack of competition in banking, however, keeps lending rates high and hinders product innovation. Looking ahead, given the importance of shifting to higher-productivity industries, the mission encourages the authorities to promote the development of the financial services industry and attract foreign investors. Doing so would also increase the competitive pressure on banks and lower lending rates.

A severe bottleneck in drafting legislation hinders supervisory reforms. Several important supervisory and anti-money laundering legislations, including the State Ordinance on the Supervision of Company Service Providers (CSP), have been stuck in
the system for a long while. In addition, the legislative framework for the supervision of the financial sector should be strengthened and extended to other sectors not yet supervised (e.g., insurance intermediaries, and investment companies). We urge the government to reallocate resources to this area to alleviate the problem.

The Aruban economy is emerging from its first postautonomy recession with strong economic fundamentals. The macroeconomic policy mix, however, is unbalanced. The fiscal stance needs to be tightened to allow the central bank to loosen monetary conditions. The recent measures to control health care costs and tackle the problems of the public sector pension system have demonstrated the government’s commitment to reforms. More needs to be done, however, to sustain the recovery in the medium term. The government needs to take measures to meet its 2005 budget target and should renew its efforts to act on its reform plans and on the recommendations of international organizations and credit rating agencies. Regarding longer-term developments, public discussion should start on the reforms Aruba needs to enhance its long-term growth potential and address population aging pressures. Early action, based on a broad social consensus, is needed to ensure fast and uninterrupted economic and social development in the long run.

Oranjestad, January 19, 2005