Centrale Bank van Aruba

Fiscal Outlook 2024-2028: Projections and Policy Implications

Research Note August 2024

CENTRALE BANK VAN ARUBA

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I. Introduction

This research note highlights the main findings of the 2024 - period 1 (May 2024) government finance projection for 2024 – 2028. It presents the key assumptions for the no-policy change outlook (i.e., baseline scenario). The analysis highlights the possible risks and opportunities for the Government of Aruba's (GOA) fiscal outcome, as well as the possible gap between this outcome and the fiscal target for Aruba stated in the LAFT national ordinance for the financial supervision of Aruba.

II. Government finance outlook

The government finance outlook projects the fiscal outcome and debt trajectory for 2024-2028. Below are the primary assumptions and the outlook for the forecast horizon.

a) Main assumptions

The baseline scenario considers the approved GOA budget of 2024 and assumes an unchanged policy scenario. Furthermore, it presumes that nominal GDP grows according to the CBA's 2024-period 1 projection for the period 2024-2028[1] (see Table 1). Inflation for 2024 is foreseen to decelerate, conform the CBA's February 2024 inflation forecast. For 2026-2028, inflation follows the projections of the IMF, as presented in their 2023 Article IV report for Aruba.

Table 1: Nominal GDP and Inflation projections *(source: CBA, IMF).*

	f-2024	f-2025	f-2026	f-2027	f-2028
GDP growth (%)	10.0%	2.1%	4.6%	3.6%	3.4%
Inflation (%)	1.6%	0.5%	2.0%	2.0%	2.0%

f = forecast

For 2024, government revenues are expected to grow according to ratios-to-GDP. For 2025 onwards, revenues are anticipated to increase according to the projected 2024 ratios-to-GDP, and build forth on the tax reforms and policies introduced in 2023.

Regarding the 2024-2028 government expenditure, personnel expenses are projected to expand with the annual automatic growth rate of 2.0 percent ("periodieken") and the 11.7 percent indexation (July 2024: 6.0 percent and January 2025: 5.7 percent). On the other hand, CBA calculations for natural attrition based on available Department of Human Resources(DRH) civil servant data and median wage are expected to mitigate part of the growth in personnel expenses. Furthermore, goods and services, and other expenditures are anticipated to increase with inflation. Interest payments are based on the Department of Finance's (DOF) interest schedule, CBA calculations, and the October

[1] As outlined in the CBA Economic Outlook August 2024 https://www.cbaruba.org/article/id/861/

2023 agreement with the Netherlands on the COVID-19 liquidity loans, while health transfers grow in line with CBA projections. The AZV expenses expand by 3.0 percent annually for 2024-2028 and projected population growth. Furthermore, investment is presumed to rise over the forecast horizon. The latter is due to anticipated large fiscal surpluses leading to the implementation of the Protocol 2019-2021 (Protocol) budget rule II.6 (to use any fiscal surplus above the established balance norm through a 50-50% distribution over debt reduction and capital investments). Additionally, expected projects related to the country reform package are included in outlays of goods and services and investment expenses. Lastly, there are no government transfers to the SVB, as according to the SVB forecast, no deficits are projected for 2024-2028.

Government debt repayments follow the DOF principal repayment schedule and CBA calculations. Furthermore, it incorporates the refinancing of the COVID-19 liquidity loans from the Dutch government to the GOA at a 6.9 percent interest rate and annual linear principal repayments. For 2024, it is expected that the GOA will meet its refinancing needs (after using the remaining fiscal surplus, following the 50-50% redistribution between debt repayment and investment, for debt repayment) on the domestic and external markets. For 2025-2027, it is assumed that Afl. 150.0 million of the GOA refinancing needs will be met on the domestic market, and the remainder will be financed externally. For 2028, the GOA is assumed to finance its maturing debt (after using the remaining fiscal surplus, following the 50-50% redistribution between debt repayment and investment, for debt repayment) on the domestic market. Finally, government lending minus repayment is held constant to the budgeted amount in the GOA 2024 budget for the entire forecasting period.

b) The no-policy change outlook

Revenues

Government revenues are expected to expand throughout the forecast period as the economy grows, fueled by the strong performance of the tourism sector (Chart 1, table 2). Government revenues are bolstered primarily by strong growth in tax revenues resulting from elevated domestic and tourism demand, as well as the introduction of the turnover tax at the border in August 2023. Tax revenues are projected to increase by 9.6 percent in 2024, after which the tax revenue growth gradually slows as economic expansion and the base effect of the aforementioned tax reform level out. Increases in receipts from taxes on income and profit, taxes on commodities, and higher turnover tax are foreseen to be the main contributors to the growth in tax revenues in 2024. The development in the tax categories mentioned above reflects vigorous business performance, as well as improved employment conditions. Furthermore, the Pandemic Resilience and Innovation Fund, assumed to be implemented in 2025, is also assumed to contribute to government revenues.

Chart 1: Government revenues *(Source: CBA, DOF)*.

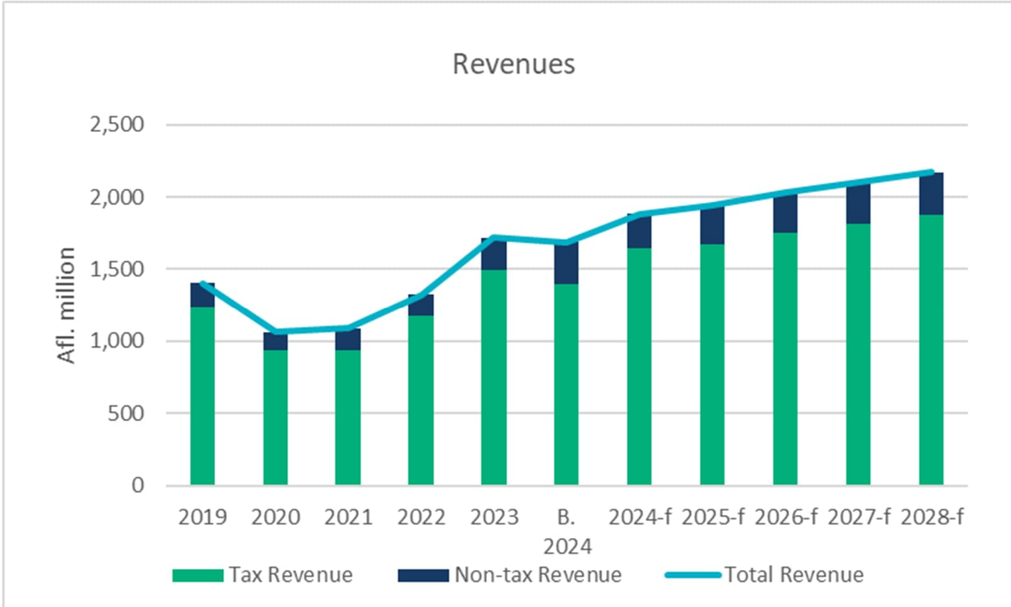


Table 2: Government revenues in percent of (nominal) GDP *(Source: CBA, DOF)*

	B.2024	f-2024	f-2025	f-2026	f-2027	f-2028
Tax revenue	20.5%	22.8%	22.8%	22.8%	22.8%	22.8%
Non-tax revenue	4.3%	3.4%	3.6%	3.6%	3.6%	3.6%
Total revenue	24.7%	26.2%	26.4%	26.4%	26.4%	26.4%

*B = Budget, GDP as outlined in the GOA approved budget 2024 (Afl. 6,828 million).
**f = Forecast, GDP conform CBA Economic Outlook August 2024.

Expenditures

Similar to revenues, expenditures are also anticipated to increase during the forecast horizon (2024-2028). Specifically, the CBA expects all expenditure components, except for interest payments, to register growth (Chart 3). Personnel costs, consisting of wages, employer's contribution, and wage subsidies are projected to grow based on the assumed 2% increase per annum "periodieken". In addition, the growth in personnel costs reflects the indexation of 6% and 5.7% to be received by civil servants in 2024 and 2025, respectively. While the CBA accounts for natural attrition and early retirement ("VUT"), the expected outflow of civil servants only partially mitigates the anticipated upward pressures on personnel costs mentioned above. Therefore, the overall costs of government personnel over the forecast horizon remain elevated. The upturn in goods and services follows the projected inflation rates over 2024 – 2028. During this period, inflation is forecasted to range between 0.5% and 2.0%. After peaking in 2024 as a result of the refinancing[2] of the short-term liquidity loans from the Dutch government that were

[2] The refinancing of the COVID-19 liquidity loans takes into account the October 2023 refinancing agreement between the Netherlands and the GOA at 6.9 percent interest rate.

due in 2023, interest payments gradually subside due to public debt reduction. However, despite the slowdown after 2024, interest expenses remain elevated compared to 2023. Total capital expenditure is presumed to follow an upward trend as surpluses remain stable and comfortably above the 1.0 percent norm in the medium term, leading to the implementation of the Protocol's budget rule II.6. With regard to the government's costs related to the provision of social security, no transfers are included to the AZV or to the SVB, as no deficits are foreseen throughout the forecast period. Last but not least, other expenditure grows with inflation, which is expected to reach 1.6 percent in 2024, and stabilize around 2.0 percent in the medium-term.

Chart 2: Government expenditures including capital *(Source; CBA, DOF).*

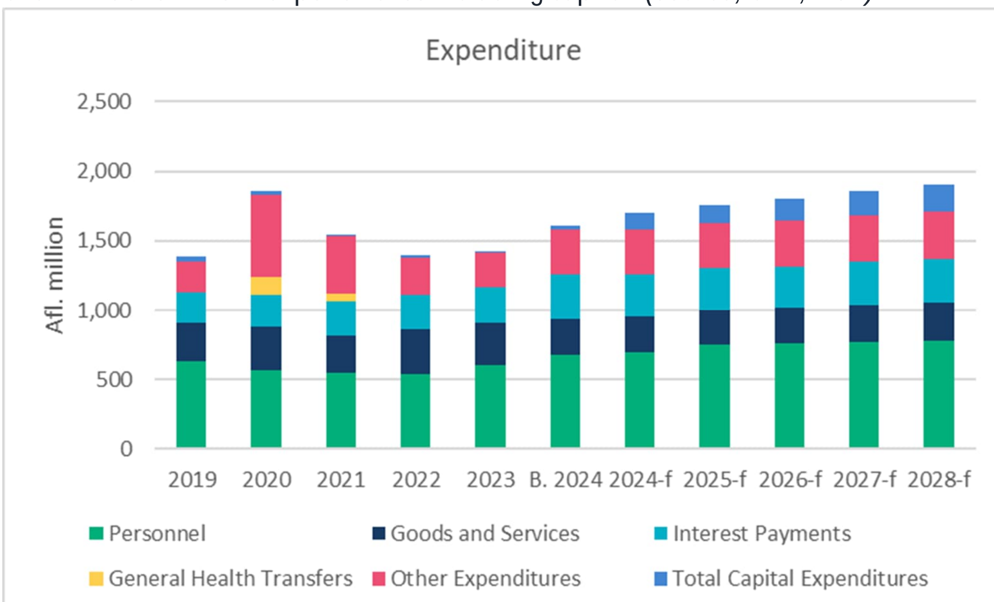


Table 3: CBA projections (2024-2028) and the LAFT agreement on surplus exceeding 1.0 percent of GDP *(Source: CBA, DOF)*

	2024-f	2025-f	2026-f	2027-f	2028-f
Fiscal balance*	167	168	209	229	251
1. Surplus excl. 50-50 agreement	261	281	341	378	420
2. of which: 1% laft	72	73	77	80	82
3. of which: >1%, 50% towards investment	95	104	132	149	169
4. of which: >1%, 50% towards debt repayment	95	104	132	149	169

*Fiscal balance = 1- 3

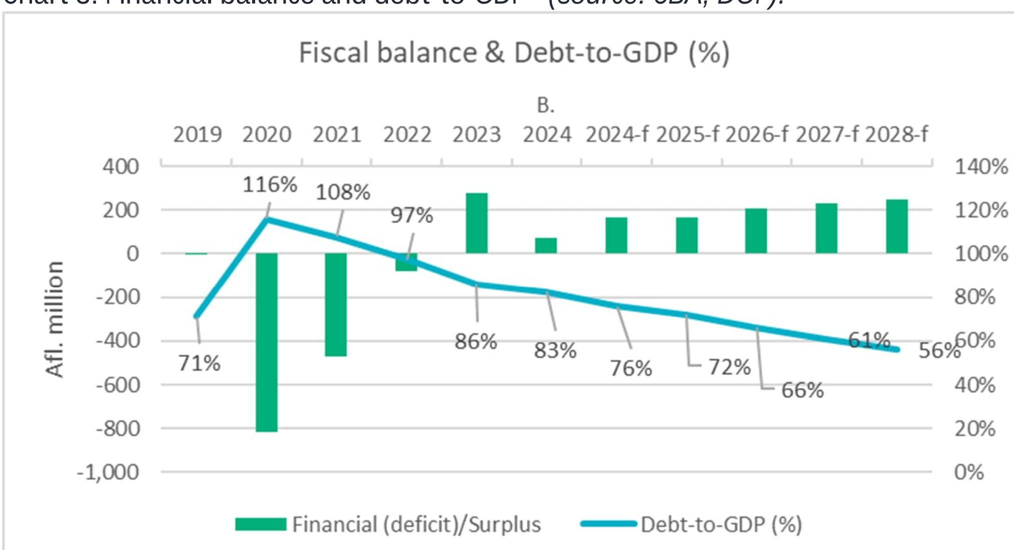
Table 4: Government expenditures to (nominal) GDP (percent)

	B2024	2024	2025	2026	2027	2028
Personnel	9.9%	9.7%	10.2%	9.9%	9.7%	9.5%
Goods and Services	3.7%	3.5%	3.5%	3.4%	3.3%	3.3%
Interest Payments	4.8%	4.4%	4.1%	3.9%	3.9%	3.9%
General Health Transfers	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Other Expenditures	4.7%	4.5%	4.4%	4.3%	4.2%	4.2%
Total Capital Expenditures	0.3%	1.6%	1.7%	2.0%	2.2%	2.3%

Fiscal balance and debt

Given the projected government revenue and expenditure developments, a fiscal surplus of Afl. 167.0 million is expected (2.3 percent of GDP), leading to a debt-to-GDP ratio of 75.9 percent in 2024 (Chart 4). In the medium term, the debt-to-GDP ratio is expected to gradually decelerate after continued fiscal surpluses (fiscal surpluses above 1 percent of GDP are assumed to go 50 percent towards debt repayment and 50 percent towards capital expenditures), reaching 55.9 percent in 2028.

Chart 3: Financial balance and debt-to-GDP* *(Source: CBA, DOF).*



*Debt-to-GDP based on CBA Economic Outlook August (nominal) GDP

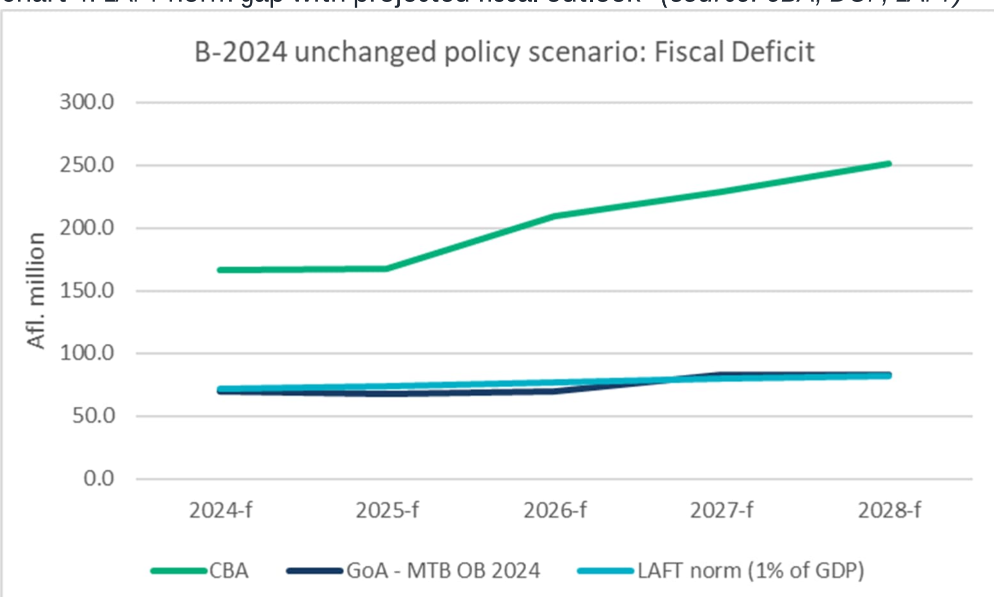
** Deficit (-), Surplus (+)

Table 5: Key fiscal indicators for the outlook 2024-2028 in ratio-to-GDP. *(Source: DOF, CBA)*

Outlook	B. 2024	2024-f	2025-f	2026-f	2027-f	2028-f
Total revenue	24.7%	26.2%	26.4%	26.4%	26.4%	26.4%
Tax revenue	20.5%	22.8%	22.8%	22.8%	22.8%	22.8%
Non-tax revenue	4.3%	3.4%	3.6%	3.6%	3.6%	3.6%
Total expenditure	23.5%	23.7%	24.0%	23.5%	23.4%	23.2%
Fiscal balance-to-GDP	1.0%	2.3%	2.3%	2.7%	2.9%	3.1%
Debt-to-GDP	82.7%	75.9%	72.0%	66.2%	61.0%	55.9%

Consequently, in an unchanged policy scenario the GOA is expected to comply comfortably with the LAFT norms requiring a fiscal surplus of 1.0 percent of GDP in 2024 (Chart 4). Furthermore, in the medium-term, increasing fiscal surpluses are expected, reaching Afl. 251.0 million in 2028 (3.1 percent of GDP). In this scenario, the GOA would continue to comply with the LAFT norms in the medium-term.

Chart 4: LAFT norm gap with projected fiscal outlook* *(Source: CBA, DOF, LAFT)*



*Debt-to-GDP based on CBA Economic Outlook August (nominal) GDP

Table 6: Fiscal balance in percent to (nominal) GDP (*Source: CBA, DOF*).

	2024-f	2025-f	2026-f	2027-f	2028-f
CBA	2.3%	2.3%	2.7%	2.9%	3.1%
GOA - MTB DB 2024*	1.0%	0.9%	0.9%	1.0%	1.0%
LAFT norm (1% of GDP)	1.0%	1.0%	1.0%	1.0%	1.0%

*MTB DB = Medium term budget included in the GOA draft budget 2024

** Ratios-to-GDP calculated using the (nominal) GDP outlined in the CBA Economic Outlook August 2024

III. Conclusion

The 2024 approved budget builds forth on the policies and tax reforms introduced in the 2023 budget. Nonetheless, the increase in government revenues is *spurred solely due to projected economic growth, and is thus subject to downside risks in the case of economic contraction.* Furthermore, despite being compliant with the LAFT norm of 1 percent of GDP, the 2024 budget still shows a significant rise in expenditure, especially due to heightened personnel expenditures and interest payments. Moreover, despite the significant surpluses in the fiscal balance over the outlook horizon, risks still loom in the medium- and long-term periods.

Risks to long-term sustainable government finances and compliance with the LAFT persist, due to increasing personnel expenses, potential general health and social security transfers, high interest expenses, and possible negative external shocks. Furthermore, the continued and increased reliance of the GOA on the turnover tax should be evaluated, as it is a distortionary and cumulative tax that is less conducive to economic growth compared to a VAT, especially considering the introduction of the 'high-income cap'[3], which will likely have a significant dampening effect on (private) consumption. As such, it is advisable for the GOA to:

i. *Work on expenditure-reducing measures and the GOA's efficiency.* Economic growth is the sole reason for the increase in revenues over the medium-term (2024 onwards). The GOA should not solely rely on government revenues to improve the fiscal balance but should work on structural expenditure-reducing measures and the GOA's efficiency, including improving the efficiency of the collective sector. Furthermore, lower GDP performance or external shocks negatively affect government revenues and fiscal outcomes. Especially since global tourism demand shows increasing signs of (post-covid) normalization. Additionally, if the anticipated natural attritions do not fully materialize, personnel expenses are likely to rise further.

ii. *Introduce a single (lower) flat VAT rate to replace the turnover tax.* Furthermore, a single rate would help simplify the intended/eventual introduction of the VAT, which could lead to better compliance and fewer distortions.

iii. *Earmark a portion of the VAT collections for the AZV as replacement for the BAZV tax and for (possible) AZV budget deficits.* Likewise, the GOA should reserve only a portion of the VAT revenues for the AZV as replacement for the BAZV tax, and request the AZV to introduce measures to ensure a neutral AZV outcome. As such, it minimizes the risk that the GOA would need to make transfers to the AZV.

iv. *Broaden and intensify compliance by continued improvement and expansion of tax compliance, tax statistics and data, as well as tax policy indicators.* Additionally, evaluate making the TD an independent revenue authority in order to further increase compliance and revenue collection efficiency.

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[3] National Ordinance (July 4 2022) – *normering topinkomens*.

v. *Curb government personnel expenditures by introducing a performance-based evaluation system and reforming GOA salary structures.* Additionally, work on policy measures that structurally decrease overtime payments.

vi. *Specify the classification for the 2027 budgeted personnel expenses (as outlined in the "Memorie van Toelichting") as it denotes the draft RAFT norm as its consideration.* The draft RAFT norm definition aligns with the LAFT norm and encompasses a broader definition of personnel expenses compared to the one currently used in the approved 2024 budget. Consequently, explicit specification of the definition/classification of personnel expenses contained in the (medium-term) budget will help ensure compliance and signal potential deviations in advance[4].

vii. *Diligently evaluate and balance investment decisions to safeguard economic stability.* Over the medium-term, augmented investment is the primary cause for the increase in expenditures. Considering the low historical investment levels, the latter is commendable. Nonetheless, the substantial sum of investments creates added pressure for a thorough procurement process and assessment of the economic and social gains of the investment project. In particular, considering the opportunity cost of foregoing the use of this sum towards debt reduction. Therefore, investment decisions should be carefully evaluated and balanced such that the gains of the investment projects outweigh the opportunity cost related to the debt and interest payment reductions. Furthermore, it is advisable to work on a multi-year investment program in order to enhance investment planning and ensure effective cost management. The latter provides a broader perspective and promotes assessment of the overall impact of investments and can help assure project prioritization and execution.

viii. *Continue and intensify negotiations with the Netherlands to reach a mutually beneficial agreement and implementation of the Kingdom Law.* The jump in interest expenses (for 2024 onwards) could have been mitigated through the agreement and implementation of a Kingdom Law. The GOA should continue negotiations and efforts with the Netherlands to refinance the liquidity loans at a lower (interim) rate to reduce the current high interest cost associated with the October 2023 agreement with the Netherlands. Also, it should intensify negotiation efforts to use the annual liquidity loan interest payments for capital investments that stimulate inclusive and sustainable economic growth. Furthermore, given the latter, the GOA should consider adaptions or clauses to the current budget rule of the 50-50% distribution based on current investment (and climate resilience) needs, and the need for and benefit of more expedient debt reduction.

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[4] At the time of the forecast, the financial agreement (signed on June 4, 2024) between the Government of Aruba (GOA) and the Netherlands regarding COVID-19 loans had not yet taken effect. Additionally, the latter will lead to new agreements for a Kingdom Law, rendering the provisions in the draft RAFT void.

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