

IMF ARTICLE IV CONSULTATION MISSION

Preliminary conclusions, December 10, 2002.

1. Since it received autonomous status within the Kingdom of the Netherlands in 1986, Aruba has achieved remarkable economic success through the development of a strong tourism industry supported by macroeconomic stability and sound institutions. The island now enjoys an income per-capita comparable to the most advanced countries and relatively low income inequality. Rapid growth in the late 1980s and early 1990s gave way to more moderate economic expansion in the second part of the decade as the tourist sector reached maturity.
2. Beginning in 2001, this structural slowdown was compounded by adverse external shocks, resulting in the first economic contraction in over a decade. After a long expansion, the U.S. economy went into a recession in early 2001, and tourist arrivals in Aruba decelerated. Later on, the terrorist attacks of September 11 disrupted air travel, further damaging tourism in the region. The sector has been slow to recover in 2002, as the upturn in the U.S. proved insufficient to rekindle tourism and weak economic conditions in Latin America depressed tourist arrivals from that region.
3. Looking forward to 2003, although household consumption in the U.S. is expected to weaken and economic activity in Latin America to remain depressed, tourist bookings in Aruba for early 2003 appear on the increase. In addition, a number of large investment projects to expand tourism capacity and improve the public infrastructure should stimulate economic activity. On this basis, and barring new adverse international shocks, we expect a return to positive growth in 2003. The strength of the recovery, however, will depend crucially on what fraction of planned investments will be carried out during the year.
4. In recent months, renewed growth of monetary aggregates made possible by the suspension of credit controls is supporting economic recovery. This expansion, however, is accompanied by accelerating consumer price inflation. At almost 2 percent, the current inflation differential with the U.S. is large by historical standards and risks undermining Aruba's competitiveness. If price growth does not subside in the next few months, the central bank should tighten monetary policy. Continuing wage moderation should also contribute to contain inflationary pressures.
5. Additional challenges for the authorities lie in the realm of fiscal policy, where the economic slowdown and the introduction of universal health insurance in 2001 compounded the fiscal difficulties already in evidence in the years of favorable growth. The fiscal deficit (including the health care fund) was 3.9 percent of GDP in 2001, and is likely to reach over 5 percent of GDP this year. Moreover, large fiscal liabilities (around 6 percent of GDP) related to past guarantees to foreign investors have emerged, and additional pending court cases could increase these losses further. The public debt is expected to grow to 37.7 percent in 2002, reflecting mainly larger external borrowing. These imbalances – if unchecked – risk creating short-term financing problems and

jeopardize long-run fiscal sustainability. Reliance on external financing, in particular, while it is still limited and helps the balance of payments in the short run, could threaten the exchange rate regime down the road, when financing flows need to be reversed.

6. We broadly agree with the government's objective to reach budgetary balance by 2007. To achieve this target, substantial adjustment needs to be undertaken in the 2003 budget, which has not been presented to Parliament yet. Most of the necessary measures are well-known, as they have been the object of numerous studies and reports (including by the IMF) in the past. We hope that the gravity of the current budgetary situation will be a catalyst for action, and urge the government – in consultation with the social partners – to take the necessary decisions.
7. On the revenue side, policies should aim at stopping the incipient decline of the revenue-to-GDP ratio but avoid raising the tax burden on labor, which is already high. The plan to increase indirect taxation through the introduction of a new tax on imports and services (the ABB) should lead to a more balanced and buoyant tax system. The authorities should decide quickly on the details of this measure and prepare its implementation. Since a new indirect tax will likely have a short-term effect on inflation, we recommend that the timing of its introduction be set in consultation with the central bank. We also welcome plans to reorganize the tax legislation in a single general ordinance, and speed up automation and improve the organization of the tax administration. A far-reaching reform of the income tax, including its simplification and a reduction in the high marginal rates, should be considered once the public accounts have improved.
8. Closing the deficit through revenue measures alone would impose an excessive burden on the private sector. Therefore, efforts to reduce public spending are necessary. In particular, in the area of health care defining a more affordable basic benefit package could help controlling costs without undermining the basic goal of universal insurance. Economies in the areas of prescription drugs also seem possible, especially if the use of generic drugs is promoted. The introduction of co-payments and deductibles, preferably differentiated based on income, would discourage waste.
9. Reducing public expenditure is hardly possible without controlling labor costs, which represent over 50 percent of the total. The long-delayed reform of the public pension system must be enacted swiftly. The system is overly generous (with replacement rates that can reach over 100 percent), and contributions represent almost 30 percent of the base wage. In addition, the expansion of public employment (16 percent since 1996) also needs to be reversed, a process that should be facilitated by the forthcoming “core business analysis” of public sector activities. The government's decision to suspend inflation indexation of public sector wages for the next three years will help contain costs in the short run, but will be just a temporary measure if wages are allowed to fully catch up at the end of the suspension period.

10. Contingent pension liabilities in the universal, pay-as-you-go system pose an additional threat to long-term fiscal sustainability. With an abrupt decline in fertility, longer life expectancy, and likely smaller immigration flows in the future, the Aruban population will age fast. The ratio of pensioners to working population is set to grow from 21.9 percent now to 63.4 percent in 2030, and the financial position of the pension fund will deteriorate quickly, especially if benefit indexation resumes as mandated by law. A reform of the system, including increasing the retirement age from 60 to 65 years and individualizing the pension, is necessary. The further development of private pensions would also be instrumental to address population aging.
11. In 2001 the deficit was financed mainly through the accumulation of arrears to suppliers and the public employee pension fund, and the stock of unmet financial liabilities reached the extraordinary level of 5.9 percent of GDP. We commend the efforts of the present government to curb the growth in arrears and encourage it to establish a timetable for eliminating the stock altogether, as the confidence of the citizens in their government suffers when the state does not fulfill its financial obligations in a timely manner.
12. Strengthening transparency and accountability in the process of budget formation, approval, and execution would also boost confidence in the government and thus facilitate fiscal consolidation. Improving the timeliness and quality of the fiscal data, particularly on expenditure and arrears, is essential in this regard. In addition, the authorities should consider strengthening parliamentary control on budget execution, restrict off-budget spending, and limit the scope for budget revisions during the year.
13. The financial sector appears to be weathering the economic downturn well so far. Bank profitability, capitalization, and liquidity remained at comfortable levels in 2001 and credit expanded at a fair pace in 2002. The authorities, though, should remain vigilant, as there are signs of deteriorating asset quality, while falling real estate prices are reducing collateral values. At a more structural level, the sector continues to be characterized by lack of competition, high interest rates, and high spreads. While the small size of the market is one of the causes, reliance on credit ceilings for the conduct of monetary policy also stifles the development of an efficient credit market. Plans to foster competition should include switching to indirect instruments of monetary policy, although at a gradual pace to avoid losing monetary control.
14. The supervision and regulation of financial institutions and the non-financial offshore sector is improving at an impressive pace, and Aruba is a leader in the region in these areas. The implementation of the supervision law for insurance companies in 2002 is a major achievement, and so are recent initiatives to supervise money transfer companies and strengthen credit risk analysis. Concerning the non-financial offshore sector, we urge the authorities to approve quickly the new law to supervise and regulate Company Service Providers, and we welcome the decision to assign the supervisory function to the central bank,

an institution with the necessary expertise and independence. These measures should strengthen the ability of Aruba to fight money laundering.

15. The planned new corporate tax regime (NFR), which would replace the existing fiscal regime for offshore companies and the tax holiday program for on-shore companies, would usefully unify the corporate profit tax rate and introduce a dividend tax withholding, in line with previous IMF recommendations. However, the use of imputation credits to reduce the tax burden on companies with certain characteristics (yet to be defined) appears complex, and a comprehensive evaluation of its possible effects both on tax revenues and foreign investment is not available. We urge the authorities to provide such an evaluation and consult with all interested parties on the basis of this study before adopting the new law. It is also essential to ensure that the new regime fulfills Aruba's commitments under the OECD harmful tax practices framework.
16. We commend the authorities' intention to turn major public enterprises, including the telecommunication company SETAR, into private law companies with greater operational autonomy. We encourage them to consider this as a first step towards opening up the capital of these companies to private investors, and, eventually, full privatization.
17. The compilation of national accounts data from 1995 to 2000 according to the SNA93 system greatly improves existing information about the Aruban economy and will provide valuable help to surveillance and policy analysis. We commend the authorities for this important achievement, and encourage them to continue their efforts by developing national account data in constant prices, expand the information on general government finances, and improve the provision of labor market statistics.
18. Finally, while the Aruban economy is heavily dependent on tourism and, like all small countries, is strongly affected by external developments, the experience of the last two years indicates that it can withstand large adverse sectoral shocks without major upheaval. Hence, while opportunities for economic diversification ought to be pursued, the authorities should continue to trust the present model of development, which they have implemented so successfully thus far.
19. We wish to thank the authorities for their excellent hospitality and cooperation.