PRELIMINARY CONCLUSIONS INTERNATIONAL MONETARY FUND 2001 ARTICLE IV CONSULTATION

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1. Since gaining autonomous status within the Kingdom of The Netherlands in 1986, the performance of the Aruban economy has been impressive. As a result, Aruba enjoys one of the highest per capita GDP in the region. Key to this success has been a high level of human capital and a stable and market-friendly institutional environment fostered by growth-oriented government economic policies. In particular, the monetary and financial stability epitomized by the fixed exchange rate of the Aruban florin with respect to the U.S. dollar has proved instrumental in sustaining investors' confidence and capital inflows.

2. Although the paucity of economic statistics in Aruba makes it difficult to assess with precision the economic conjuncture, it appears that output growth picked up in 1999 and early-2000 mainly as a consequence of increased tourism receipts but also buoyant domestic demand conditions. Since then, output and demand growth have softened reflecting the evolution of tourism receipts and a decline in investment as several large construction projects were completed. After falling for several years, inflation rebounded in 1999 and accelerated in 2000 to 4 percent, owing mainly to imported fuel costs, but also to rapid credit expansion through the first quarter of 2000 and government spending in wages and other consumptive outlays.

3. Looking forward, the most likely prospect for 2001 is a further deceleration of output growth. The primary cause of this envisaged slowdown is the ongoing deterioration in the external outlook which will negatively affect both demand for tourism services in the main markets of origin, notably the United States, and foreign investment and capital inflows. Further ahead, economic growth is projected to stabilize or even experience a modest recovery in 2002 reflecting the expected evolution of the U.S. economy. These projections, however, are subject to a high degree of uncertainty as the openness and small size of the Aruban economy make it difficult to forecast the effects of external shocks.

4. Regarding economic policies, the mission broadly agrees with the objectives of the authorities to enhance long-term growth prospects and minimize output volatility by fostering the diversification of the economy into high value-added sectors that profit from the comparative advantages of Aruba, including a skilled labor force, while consolidating its position in the upper segment of the market for tourism services. Economic policies can make significant contributions in this direction. First, pursuing prudent and disciplined fiscal policies expands the pool of domestic savings available for private investment and underpins investors' confidence- while freeing budgetary resources for investment in infrastructure and human capital. Second, maintaining the strength of the monetary and financial framework through a sound foreign reserve position and increasingly effective supervision and regulation of onshore and offshore financial activities enhances stability and transparency as well as the international attraction of Aruba as a safe destination for long-term investment. And finally,

continuing progress in the orderly liberalization of financial and external capital account transactions; advancing in the privatization process; and avoiding involvement of the government in business ventures foster the efficient use of available resources and attract investments and entrepreneurship.

5. In this connection, the mission is concerned about growing imbalances in the public finances stemming from benefit entitlements and structural budgetary consumptive spending, notably on public wages. These imbalances already have adverse macroeconomic implications and a widening government financing requirement risks compromising eventually the enviable financial and monetary stability of Aruba. The mission estimates that the government deficit grew from 0.3 percent of GDP in 1999 to 0.7 percent of GDP in 2000, mainly as a result of higher current spending. But more importantly, unless measures are promptly taken, the deficit may step up to a much higher level in 2001 as a consequence of the introduction of the universal health care coverage system (AZV); increases in the wage bill; and lack of tax revenue buoyancy.

6. Therefore, the mission urges the authorities to introduce without delay measures to consolidate the budgetary position and draw up and implement a realistic plan to achieve their objective of a balanced budget, with the overall aim of bringing long-term solvency to the public finances. In the short term, budgetary discipline should be strengthened and current spending contained to a level that can realistically be financed. Also, tax collection efforts should be intensified. On policies with a medium-term orientation, we encourage the authorities to restructure the system of entitlements in order to place the health and pension systems on solid financial grounds, and to accelerate their plans to strengthen budgetary procedures and reform the tax system and administration.

7. Restraining government current expenditure in the short term is perhaps the most arduous task but also the most needed since current, spending precludes necessary investment outlays and could reach unsustainable levels. Wage moderation in the ongoing wage negotiations is crucial to achieving success in this area. The government wage bill represents about half of total revenue and a similar proportion of total expenditure; while wage hikes and expansion of public employment raised government labor costs by over 11 percent in 2000. From this high level of spending, consolidating the public finances requires limiting increases in the overall wage bill to well below expected inflation and refraining from increasing the total number of government employees. These short-term measures should be followed by a long-term rationalization of public employment policies in accordance with the authorities' public policy priorities.

8. In the area of spending on goods and services and payment arrears with private suppliers, substantial progress was made in clearing the stock of outstanding obligations in 1999, but arrears accumulated again in 2000. Clearing arrears should be an immediate priority as they fuel demand for distress credit by liquidity-squeezed suppliers and have, a deleterious effect on budgetary management and tax compliance through hard-to-control tax offsets. We encourage the authorities to intensify their efforts to strengthen the budgetary

process and expenditure management and administration. In this regard, we suggest that international standards of budgetary accounting and reporting be introduced along the lines of the European System of Accounts (ESA) and that budgetary and treasury management be reinforced through administration and procedural reform.

9. Generous health care and pension entitlements also constitute a major source of budgetary strain that needs to be contained. In particular, the introduction of the new AZV system will be among the main causes of a widening deficit in 2001. While we concur with the authorities on the high priority accorded to health care, ensuring continued provision of these services requires a definition of entitlements that is consistent with available revenue. We hope that the ongoing study on the prospective costs of the AZV will serve as a starting point for reforms that place this agency on a self-financing basis- without budgetary help beyond the statutory government contribution as an employer and perhaps a limited subsidy targeted to low-income groups. In the immediate term, however, remedial action is already necessary to alleviate pressure on the budget. Although efforts are being made to introduce cost-cutting measures, these should be intensified and complemented by the introduction of co-payments by beneficiaries to relieve the financial position of the AZV and prevent unnecessary costs and abuse. Further budgetary savings will require increasing payroll contribution rates.

10. Expansion of pension entitlements over the years in both the public employees, (APFA) and general (AOV) pension systems has placed an increasing burden on current revenues while demographic trends point also to growing future public liabilities. The ongoing actuarial analysis of APFA should be accompanied by a similar analysis of AOV and followed by a far-sighted reform of pension entitlements and future government obligations with a view to guarantee their financial viability and reduce the present burden on public finances. Initial actuarial results on APFA have prompted the preliminary decision to cancel accumulated budgetary arrears to this fund. This decision in itself, however, is not a solution to the weaknesses of the pension system as it has not diminished current or future obligations of the public sector as a whole (for which the budget stands as ultimate guarantor) nor has it increased the revenue available to finance these obligations. Any final arrangement should ensure that budgetary transfers are sufficient to preserve the fully funded nature of the future obligations of APFA. That is, existing investments necessary to meet future obligations should not be used to pay current pensions or the dearness allowance.

11. On the revenue side, the mission encourages the authorities to develop and pursue their projects for the reform of the tax system and administration while immediately intensifying efforts at tax collection. A blueprint for comprehensive tax reform should aim at enhancing revenue elasticity, rebalancing the tax mix toward consumption taxes, and simplifying the tax system. Tax revenue as a percent of GDP shows a secular declining trend that was only partly contained in 1999 and 2000 by means of two one-time revenue-raising measures. The causes

of this lack of buoyancy include the complexity of the tax system, which facilitates noncompliance, and the excessive reliance on excises and import tariffs. Thus, the mission recommends that the authorities consider the introduction of a tax on final consumption, along the lines of a VAT. Shifting the balance of taxes toward consumption could provide room to reduce the tax wedge between labor costs and take-home wages, which is high in Aruba. We also recommend that the authorities refrain from renewing tax holidays or granting new tax concessions as they result in untransparent tax privileges and revenue losses that the budget can ill-afford. The mission congratulates the authorities on the preliminary agreement reached with the OECD on the matter of harmful tax competition practices.

12. The Central Bank of Aruba (CBA) must be commended for its prudent and skillful management of monetary policy as demonstrated by the continued credibility and strength of the peg to the U.S. dollar, buttressed by a robust foreign reserve position. The mission endorses the tight credit stance adopted by the CBA in early 2000 in response to a pickup in inflation, rapid credit growth, and an overheating economy. The 12-month inflation rate has already declined by more than one percentage point since its peak in mid-2000 and should decline further as a result of softer external demand and the lagged effects of tight liquidity. The current target for credit expansion in line with expected nominal GDP growth is adequate- but the CBA should stand ready to tighten its policy stance should shortfalls in external receipts or capital inflows point to an erosion of the foreign asset position of the monetary system below the CBA target floor.

13. The mission supports the authorities' efforts to introduce more flexibility in the monetary policy framework. The CBA instruments for the conduct of monetary policy remain essentially limited to direct credit ceilings, moral suasion, and occasional changes in the banks' liquidity requirements. Although direct credit ceilings on the banking system have proven effective in curbing inflation and defending the foreign reserve position of the economy and should remain in effect in the immediate future, they also have undesired side effects. When maintained for a long period of time, as has been the case in Aruba, they tend to freeze market shares and hamper competition in the financial sector. The mission advises an incremental approach to financial liberalization- including a sequenced relaxation of restrictions on external capital transactions- on the basis of a parallel strengthening of prudential and liquidity requirements and the introduction of market-based indirect instruments of liquidity management. Progress in this direction will foster innovation, productivity, and cost-efficiency in the financial sector- to the benefit of economy-wide productivity and business costs- while deepening the local market in financial instruments.

14. The mission commends the authorities for significant progress in expanding and strengthening the supervisory and regulatory framework of both onshore and offshore financial activities. The decisive actions taken and the authorities' proactive approach to fighting crime related to international transactions should go a long way in consolidating the standing of Aruba as a safe and stable

destination for foreign investment vis-à-vis the international community. Testimony to substantial advances in this area are the recent passage by Parliament of the law on insurance supervision which will be enacted in July 2001; the designation of the CBA as the regulator of company service providers in the offshore sector; and planned changes in the licensing system of company service providers that will introduce 'fit and proper' management requirements, reporting obligations for unusual transactions, and standards of disclosure and transparency. Also, Aruba is in the process of completing the first phase of an offshore financial sector assessment (OFC) and participates in the Coordinated Portfolio Investment Survey (CPIS), both with assistance of the IMF.

15. The mission encourages the authorities to regain the initiative in the area of privatization and other structural reforms. Plans to transform the telecommunications operator (SETAR) into a public corporation run on the basis of commercial criteria could be a first step in this direction. In the medium term, however, full privatization by selling SETAR to a private strategic investor could provide a vehicle for the acquisition of technical know-how and much needed investment in the sector. Incorporation of the Aruba Tourism Authority (ATA) as a commercial enterprise with private sector participation and full management and operational autonomy should improve the cost-efficiency of this agency and facilitate the development of its marketing strategy.

16. The CBA has made significant progress in the publication (including through the internet) of statistics on money, banking, and the balance of payments. Also, the upcoming publication of the Census 2000 by the Central Bureau of Statistics (CBS) will constitute a valuable contribution to the statistical base of Aruba. In contrast, progress in the timely compilation and publication of statistics on national and public sector accounts, labor markets, and other basic economic indicators remains disappointing. As a result, not only economic surveillance but also effective policy making and economic decisions by the private sector are seriously hindered. Improving the statistical base should be accorded high priority and sufficient resources should be devoted to the CBS. In the case of public sector and budgetary statistics, their regular compilation and publication by the Ministry of Finance under standard international accounting conventions (for example, along the lines of the European System of Accounts) would be an important contribution to the transparency of the budgetary process.

17. Finally, the mission would like to express its gratitude to the authorities for the excellent cooperation that it has received and for their hospitality.