Sound public finances

A solid foundation for sustainable growth in the Caribbean part of the Kingdom

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The last time I was in this arena we spoke about the need to raise economic growth, which was during a seminar titled **Towards a strong economy for Country St. Maarten,** organized by the University of St Maarten and the Ministry of Economic Affairs. Tonight I have the privilege to stand before you again and we will again talk about economic growth, but this time from a completely different angle, namely sound public finances. We will look back on five years of financial supervision within the Kingdom and we will also look forward to 2015, an important and special year. This presentation is partly based on my contribution to the celebration of 200 year kingdom. The Kingdom is what connects us. If you want to do business with each other or jointly want to conquer the world, it helps if there is something as tangible and visible as the Kingdom.

All countries within the Kingdom are facing the challenge to get their budget balanced. Within the Kingdom especially Curaçao and the Netherlands have implemented sizeable budgetary measures, sometimes with painful consequences. Also Sint Maarten had to take painful measures to balance the budget for this year. Aruba is acutely aware that action is needed and has announced the first steps to that effect at the end of last year.

We are not alone in this. Fiscal challenges are a global phenomenon, from which virtually no country can escape. In the United States it takes the greatest difficulty to find a majority in Congress to increase the debt ceiling. The debt crisis in Europe has shaken the Euro area. Enforcement of fiscal discipline from Brussels has now been established in the European context.

Obviously it is difficult to maintain sound public finances on your own.

The challenges facing the different budgets within the Kingdom are even more significant because they go hand in hand with low economic growth. It sometimes seems that we are in a vicious circle of low growth, rising deficits, budget cuts, leading in turn to lower growth. How can we escape from this vicious circle?

Where do these budget problems come from? First of all, we all suffer from the aftermath of the economic crisis. What also adds to the predicament: life expectancy is increasing everywhere and the population is aging. This was not taken into account, back then when we set up our pension plans and schemes. Finally, due to the aging population and the increased cost of medical care through technological progress, the costs of health care are increasing everywhere.

What makes countries within the Kingdom special is that they all have small and open economies. Of course, the Dutch economy is by far the largest, but in Europe, the Netherlands has nevertheless a relatively small economy. Being small and open means that a fiscal stimulus will quickly leak abroad in the form of increased imports.

Fiscal policy within the Kingdom is thus not a good instrument to stimulate growth. To create jobs, investments in the private sector need to be encouraged. And this can only be done when a prudent fiscal policy is being implemented.

We, the Kingdom, therefore appear more alike than we sometimes realize.
In the two years that I am the chairman of the Cft, I often encounter wrong perceptions.

The black and white images that are sometimes heard in the Netherlands about Sint Maarten and Curaçao relate to the misconception that the money from the debt relief has already evaporated and that money is still being sent to these countries. On the other side of the ocean we hear in Sint Maarten and Curaçao that the promised healthy starting position has not been adhered to, and that there are such stringent budget requirements in the Kingdom law, that the fragile island economy is being destroyed. Both images are not correct.

Actually, we know too little of each other and we like to think in patterns that we hardly let go off.

I therefore thought; let's begin with a short quiz just to see if we have the right image of each other. I have eight questions for you to answer.

I begin with two easy general questions, followed by six questions on the subject of this lecture. Here are the questions:

1. Where is the highest point of the Kingdom?
2. How many official languages does the Kingdom have?
3. Which country in the Kingdom grew the fastest since the new millennium?
4. Which country in the Kingdom grew the fastest since 10-10-10?
5. Which country has the most expenditures on health care as a percentage of its GDP?
6. Which country has the highest government debt as a percentage of its GDP?
7. Which country saw its credit rating improve in 2013?
8. Which public entity (BES islands) ended 2012 with a budget surplus?

You will get the answers at the end of my lecture.

Back to fiscal policy. Sound public finances are the raison d'être of the Board of financial supervision: the reasoning of the debt relief program was to perpetuate the sound public finances. We not only act as a regulator but mainly as a trusted advisor. An important part of that task is to give advices that are clear and transparent with regard to the actual situation.

All countries within the Kingdom are under financial supervision, with one exception: Aruba.

The Netherlands is under scrutiny of European supervision, enshrined in the Maastricht Treaty. The European Commission has an advisory right, embodied in early warnings if the government finances threaten to derail and may issue sanctions if countries do not comply with the agreements. The European Council of Ministers can only in very rare circumstances prevent this from happening. So an important part of the budget sovereignty lies in Brussels.

The financial supervision of Curaçao and Sint Maarten shows many similarities. The supervision is governed by a Kingdom law. The Cft has similar instruments as the

Commission, with the big difference that the Cft can recommend to give an instruction, but it is the Kingdom Council of Ministers that decides ultimately. An interesting innovation laid down in the Kingdom law, states that deficits must be compensated within three years.

We do have to realize that although the legal form of the supervision is very similar, the underlying framework is very different. As King Willem-Alexander said: ‘Uniformity and Diversity” certainly apply here.

The Netherlands have to adhere to European rules that everyone knows by heart nowadays. The deficit of the general government, including all public investments, must be less than 3% of GDP and total public debt must not exceed 60% of GDP.

Sint Maarten and Curaçao in contrast must balance the current account, thus current expenditure and income must be in equilibrium. This seems at first sight more stringent than the European rules. But that is not the case, because deficits for public investments are permitted, as long as the interest costs are lower than 5% of government revenues, and the budget, excluding the capital account, is balanced in multi annual terms.

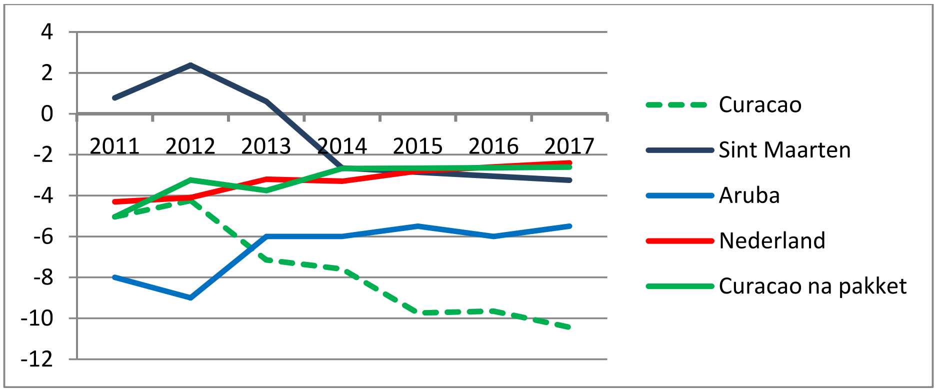
In public finances this is called ‘the golden rule of financing’. It owes that beautiful name to the following rationale: public investment strengthens the economy and therefore future generations benefit from it. Therefore borrowing is allowed: investments pay back after all.

The public entities (BES Islands) again have to do with a different system. There is no distinction between current and capital expenditures. The total budget must be in balance. However, interest-free loans can be drawn at the ministries of the Netherlands, on the condition that the repayments can be accommodated within the budget.

The different contexts with regard to the budget are therefore not easily comparable. In addition the islands, like the Dutch municipalities, have an accrual based administration, whereas the Dutch State budget is drawn up on a cash basis.

In the graph below I compare the countries in the Kingdom on the same basis with the prevailing European EMU deficit. This creates an interesting picture. The calculated deficit of Curaçao and the Netherlands do not differ much, and as from 2014, Sint Maarten falls in the same range. For Aruba we used the estimates of the IMF, but in the coming period the government of Aruba is trying to reduce the deficit to a level comparable to the other countries in the Kingdom.

Graph 1: Budget surplus and deficits within the Kingdom



Source: Central Bank of Curaçao and Sint Maarten, IMF Article 4 consultation Aruba 2013, Miljoenennota 2014,effecten beleidspakket Curaçao (Cft 2013), Annual reports SVB Curaçao, Annual reports SVB en AZV Aruba, Annual reports SZV Sint Maarten, calculations Cft

The dotted line for Curaçao indicates how the deficit would have developed without additional measures. Particularly striking is how quickly the deficit would have increased towards 10% of GDP, if no decisive action would have been taken!

With a comprehensive package to balance out the budget, which was referred to by the government of Curaçao as the ‘cold turkey approach’, the downward trend reversed during 2013. The scale of the measures is enormous; if the Netherlands would have done the same, this would have resulted in budget cuts of a multiple of € 6 billion, which is the size of the budgetary cutbacks in the Netherlands this year. This is also recognized by the credit rating agencies: the rating of Curaçao increased from a negative outlook to a stable outlook.

Since the 2013 current account of the budget (excluding the capital account) is balanced, Curaçao can now borrow for public investments, particularly for those in infrastructure and the building of a new hospital, so that the total budget still shows a deficit.

The same goes for country St. Maarten, as it will be able to borrow for public capital investment during the coming years, when a balanced budget is soon submitted to the Cft, which meets the criteria of the Kingdom law.

Sint Maarten is an interesting country within the Kingdom. Economically speaking, Sint Maarten has performed very well over the past decade.

In recent years it has shown steady, albeit modest economic growth in the range of 1 to 1.5% in recent years. The budgetary problems are much smaller than those of Curaçao, the Netherlands or Aruba. This is because Sint Maarten has a far younger population, well-capitalized social funds and healthy government owned companies, financially speaking. Government debt at around 30% of GDP is relatively low. There is a credible exchange rate link with the US dollar.

At the same time the government is characterized by weak finances, which has made it difficult for the government to provide the level of public services which matches with the aspiration levels of the population. Of particular concern is the apparent failure to raise additional tax revenues. Tax revenues in the recent period have been basically flat, if not declining. Tax revenues were ANG 411 mln in 2011, 416 mln in 2012 and are expected to be in the order of ANG 405 mln in 2013. Since Sint Maarten has not been able to borrow for investment since past budgets were not drawn up in accordance with the Kingdom laws, the liquidity position of the government has shown steady deterioartion to the point that something needs to be done.

These issues show that Sint Maarten faces much greater governing challenges than other countries in the Kingdom. In a very short timeframe, new institutions, such as High Councils of State and public services formerly carried out by the country the Netherlands Antilles, had to be built nearly from scratch, and financed from its own budget.

Let's take a closer look at government revenues. Over the three-year period 2011-2013 cumulative growth of nominal GDP, that is the sum of real economic growth and price inflation, has been close to 13 %. On the other hand, over the same period, tax revenues remained stable. If tax revenue collection would have kept pace with nominal GDP growth there would have been additional fiscal space of ANG 55 million.

The budgetary processes in Sint Maarten have been cumbersome. Since Sint Maarten became a country if its own, it has not been able to sign off a budget before the beginning of the new year. 2013 was a particular bad year since the budget was finally approved as late as September. If the government can make progress to finalize the budget 2014 in the coming week than 2014 will mark a significant turn for the better.

Therefore, the policy agenda for Sint Maarten it seems to me is quite clear. I
For the government to be able to provide the basic services to the population it is imperative to increase the tax base and improve tax compliance. In doing so, it is important that the strongest shoulders bear the heaviest burden. Than it is also imperative to strengthen financial management and adhere to the timelines for an orderly budgetary process.

The good news here is that upon positive advice on the budget 2014 Sint Maarten can borrow for capital expenditures and this will help improve liquidity position. I am optimistic that we can reach agreement this week in our talks with the government on an investment program, to be financed at relatively cheap interest rates, using the triple A status of the Netherlands.

In the longer run, structural measures are needed as well. There is a need to strengthen health care and raise the retirement age, just as all other countries in the Kingdom have done. Sint Maarten is lagging behind here. Without due policy, as of 2017, the surplus of the social security funds will turn into deficits and these deficits will have eaten up the reserves by 2027. Sint Maarten should anticipate for this, by gradually increasing the retirement age.

So, to sum up here, higher economic growth in St. Maarten has not been translated into greater fiscal space. Despite the growth, total revenue from tax remain nominally equal, which is worrisome.

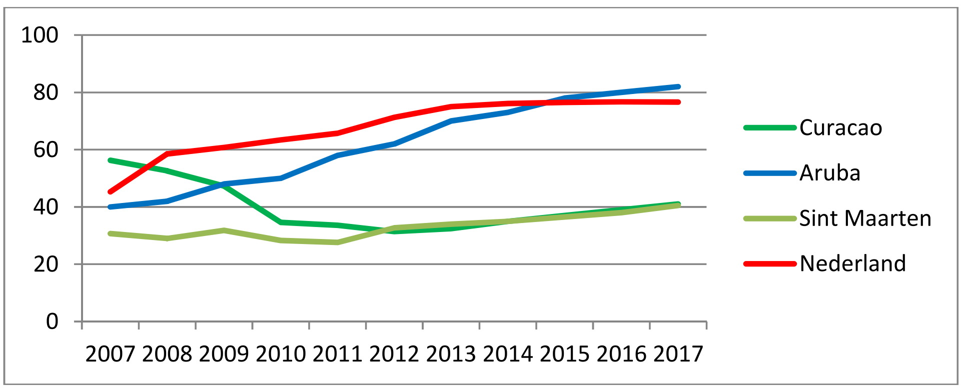
Sint Maarten is in favor of a so-called small government and therefore perhaps is the most Anglo-Saxon country within the Kingdom. There is a can-do mentality which other countries can learn from. But I think the limit is reached, and that an increase of the tax revenue is necessary to stem the major informal economy, rising income inequality and insecurity.

Aruba, finally shows the highest deficits within the Kingdom. Also on Aruba social security and health care funds are in a precarious situation which calls for short term intervention. The new government has expressed the intention to freeze spending nominally, increase the retirement age and other major measures, to cut back on government deficits and balance the budget in the years to come.

I hope I can replace it with a dotted line in this graph in the short-term forecast for Aruba and can say, 'this is how it would have looked like on Aruba, if no decisive action would have been taken'.

What does this all mean in terms of debt? Chart 2 shows how the debt will evolve from 2007 to 2017. The Netherlands expects a stabilization of the debt ratio around 77%. Aruba, according to the latest IMF estimates, will even go beyond this ratio. As known, the countries of Curaçao and Sint Maarten have benefitted from the debt relief program, which brought them to a level of around 30 to 35%, but due to capital investment, debt will gradually increase.

Graph 2: Debt ratios within the Kingdom



Source: IMF Article 4 consultation Curaçao and Sint Maarten (2011), IMF article 4 consultation Aruba (2013), Miljoenennota 2014, calculations and estimates Cft for Curaçao en Sint Maarten.

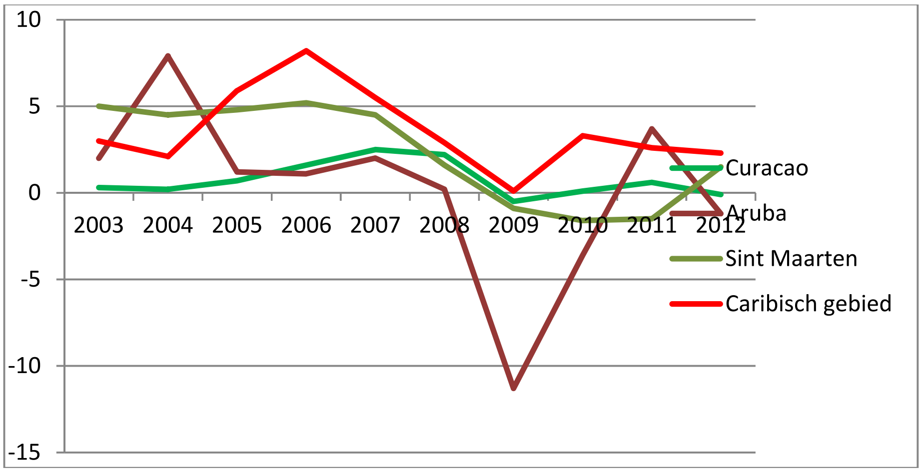
The implications this has for the interest expenses vary enormously between the countries. Even though the Netherlands currently has the highest debt, interest costs do not exceed 3.5% of government revenue, because it can borrow cheap. Because of the debt relief program, the interest expenses for Sint Maarten and Curaçao are even lower at 2.5 %. The comparison shows very high interest expenses in Aruba of 10% of government revenues, which makes clear that sizable measures are urgently needed.

Much has been accomplished in the area of sound public finances. This is an important prerequisite to even higher economic growth in the future. The Kingdom law facilitates this through the possibility of public investments at a low interest rate, as long as the current account of the budget is balanced. Sint Maarten and Curaçao have worked hard in recent years to balance their budgets. Therefore, the benefits of that hard work and, as a result, the financial basis, is ready for them to be achieved.

Higher economic growth is a must. Chart 3 shows that the growth in Curaçao and Aruba has lagged behind that of the Caribbean. The countries in 2013 more or less back to the prosperity of the early century. Netherlands also showed little growth over this period.

Sint Maarten, with growth of 20% over the past 10 years, is the only country in the Kingdom that is substantially better off in 2013 than at the beginning of the century.

Graph 3: Comparison economic growth in the Caribbean



Source: Centrale Bank of Curaçao and Sint Maarten, Centrale Bank of Aruba, IMF World Economic Outlook 2013, IMF article 4 consultation Aruba, Draft budget 2014 Curaçao, IMF article 4 consultation Curaçao and Sint Maarten (2011)

The latest estimates suggest that St. Maarten and Aruba are recovering again. The economy of Curaçao has suffered this year from the sizeable measures to balance out the budget, but the effects are less severe than expected. This has everything to do with the measures led to reduced imports, but did not affect domestic spending. In economic terminology, the multiplier of fiscal policy in a small open economy is very low.

So there is a sound financial basis for accelerated growth. The view of the Kingdom as a hub to the rest of the world, with the Netherlands as a hub to Europe and the Caribbean countries as a hub to North and South America, can certainly help.

The Kingdom is a magnificent concept, together we can excel in several markets! Together we cover three continents, where the economic climate is rarely the same. If Europe is in a recession, it is may be possible that North America is doing better and that South America might be even catching up, as we already seen happen. The Kingdom is located very strategically, so it can reap a piece on all shorelines.

For doing business in general it is of the utmost importance that parties are transparent, so they can trust each other. Certainly within the Kingdom this is important, where in addition to many similarities, many differences in culture and language exist. I venture the assertion that it is worse for the business climate in a country that entrepreneurs are in the dark about the state of the public finances, than about the actual deficit and debt figures. After all, if entrepreneurs do not trust the government, doing business is a very risky venture.

It is also good for investors to know that the Kingdom advocates a practice of fiscal discipline and effective financial supervision.

Making things transparent is trickier than it seems at first glance. Especially in the countries of the Caribbean part of the Kingdom, transparency can sometimes be politically sensitive, knowledge is power. Advanced statistics, but also web pages and libraries where laws and records of meetings are easy to find, are lacking in all three countries.

We try to contribute to a better access to public information and transparency through tight monitoring of processes and procedures with regard to publication of all our advices. This should also be best practice for other advisory councils within the Caribbean part of the Kingdom. In addition, I would like to advocate for a stronger and more explicit role of the Parliament of Sint Maarten and Curaçao, as well as the Island Councils of the public entities (BES Islands) in order to keep government accountable.

Large improvements can be made in making doing business easier. There is still too much bureaucracy and cumbersome administrative steps that stand in the way of doing business. The purpose should be aimed at more foreign direct investment, which can lead to visible improvements of the living conditions within the Kingdom.

The regulator is dependent on good information from the government. A lot has been done in this regard in recent years. It has become clear that financial information about the semi-public sector and government owned companies is necessary to get the picture complete. The biggest setbacks occurred in this less controlled environment. We also learned that it is important to work with independent growth estimates, in order to prevent governments from working with unrealistic revenue ceilings.

Looking back and taking everything into account, there is much to be pleased about and we can look at the future with confidence. Supervision works best when executed by independent outsiders. The independence of the Cft is guaranteed by the unique composition of independent experts from the countries and public bodies that operate without interference or consultation.

It does become clear - and the European experience does not show otherwise - that a credible threat of sanctions is necessary for supervision to be effective.

But ultimately, effective supervision and recovery of economic growth depends on political stability. In the nearly two years that I am the chairman of the Cft, I met with 4 different governments in Curaçao, 3 on St. Maarten, in the Netherlands I met 3 ministers of Interior Affairs and Kingdom Relations, and on both Bonaire and Sint Eustatius with 3 commissioners. Only in Saba I still speak the same members of the Island Council and Executive Council. Political stability is a prerequisite.

Finally: financial supervision as we know it will be evaluated in 2015. There has been much progress in the area of sound public finances and it would be good to build on what has been achieved after 10-10-10.

The Kingdom law has two areas of focus: one being the balanced budget over a period of three years, the other sufficient improvements in public financial management compared to the start of financial supervision. This will be established by an independent committee that will report to the Kingdom Council of Ministers directly. The evaluation can also be used to address possible bottlenecks. An important question is how to deal with government owned companies, which in principle form a significant risk to the government's budget.

A positive development is that the countries are considering to set up their own budget chamber. This could help Parliament to get well informed before going into a discussion with government about the budget. It will be important however, for the budget chamber to operate independently, similar to the Congressional Budget Office, which advises the U.S. Congress. But experience shows that this does not guarantee sound public finances. A budget chamber therefore differs from a financial supervisor like the Cft, which is mandated by law and can issue sanctions or penalties.

In the past two years I have seen and experienced the added value of financial supervision within the Kingdom. It also provides a common ground to address and mirror each other on the basis of equality. In my view, the added value of the Kingdom is also: learning from each other's experiences and make use of each other's expertise. The latter could be practiced some more in the Caribbean part of the Kingdom. The countries still want to do too much all for themselves, reinventing the wheel, which costs too much in terms of capacity and money. Shared service centers should in my view be investigated more.

An important advantage of the Kingdom is that it can be used to finance public capital investment through the triple A rating of the Netherlands, of course within the legal framework of the Kingdom law. That is a direct financial benefit of being part of the Kingdom.

I will conclude. When we want to “get together to earn a lot of money", as Prime Minister Rutte said not long ago, let's start to understand and get to know each other better. So we need to actively work on imaging, based on facts. Working together and doing business together in the Kingdom presupposes that we immerse ourselves in each other, on an equal basis. The Kingdom must be a basis for mutual collaboration and trust. Together we are the Kingdom and together we can create an image that the Kingdom is a good place to do business. With this lecture I hope to have addressed the area of finance that gives confidence and thus forms a good basis for sustainable growth recovery in the Caribbean part of the Kingdom.

Before I forget and give the floor to our students, I will give you the answers to the quiz at the beginning of my remarks. How is your score? I hope this quiz is an incentive for us to delve into each other more.

Do we have the right perception of each other?

1. Mount Scenery on Saba
2. Four: Fries, English, Dutch, Papiamentu
3. Sint Maarten
4. Aruba
5. Curaçao
6. The Netherlands, but Aruba is fastly approaching
7. Curaçao
8. All three: Bonaire, Saba and Statia

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