

Toward a Comprehensive Solution of the Debt Problem

*Speech by Dr. E.D. Tromp at the conference **The Comprehensive Development of the Islands of the Netherlands Antilles.***

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Ladies and gentlemen, good morning,

Allow me to express my appreciation to the University of the Netherlands Antilles, which in collaboration with the "Nationaal Comite" and the "Oranje Comite" organized this series of seminars culminating in a conference whose central theme is "The Comprehensive Development of the Islands of the Netherlands Antilles." In particular, the social dimension of the seminars' sub-themes and the link with the universal reference point for poverty reduction, the Millennium Development Goals (MDG)[1] of the United Nations is a welcome addition toward better understanding of the financial-economic challenges of our country.

While this seminar was organized to commemorate the 25th anniversary of the ascension to the throne by Her Majesty the Queen of the Netherlands, important constitutional changes within the Kingdom also are about to take place. On the 26th of this month a Round Table Conference will be held to set the stage for implementing the results of the various referenda recently held in the Netherlands Antilles. Those constitutional changes will certainly bring their pressure to bear on the economies of the various islands.

Ladies and gentlemen, I have been asked to provide you with an overview of one of our most nagging problems, namely, the outstanding public debt within the context of sustainable development. Unless actions are taken, our debt problem poses serious risk to our sustained growth and, hence, to the goal of improving the standards of living for us all.

Sustainable development has both an economic and a social dimension. The field of economics that studies this – not surprisingly – is welfare economics. An important tool in welfare economics is the social welfare function, which describes the relationship between the welfare of society as a whole and all the variables affecting the state of the economy and the quality of life. As such, this function describes the level of social-economic development of a society and includes issues like income distribution, public health, education, housing, the environment, political freedom, civil rights, and good governance to mention a few examples. The United Nations has developed an indicator of welfare, namely, the Human Development Index, which measures the level of social-economic development of a country. By comparing the actual level of welfare with a desired level, policy makers can formulate objectives and policies to achieve those objectives.

Since my field of expertise is in the economic dimension of welfare, I will focus mainly on the public debt problem of the Netherlands Antilles and its impact on the realization of social objectives. However, I will, not discuss these objectives themselves.

My presentation is structured as follows. First, I will provide you with an overview of the main developments with respect to our public debt and point out the consequences of the high level of debt for our welfare. Next, I will elaborate on the policies needed to reduce the debt to a sustainable level and will discuss the issues arising from eventual constitutional changes. This discussion will lead to a specific proposal that would significantly reduce the debt thereby creating financial room to address the challenges of the new constitutional arrangement for the islands and to improve the welfare of their people. Finally, I will conclude by summarizing the major findings of my presentation and formulating some policy recommendations.

Ladies and gentlemen, attention to the rising level of public debt is not a recent phenomenon. Rather, it dates back to the mid-nineties, beginning with a 1994 report by dr. Kees Goudswaard in 1994 titled "Towards controlling the Antillean Public Debt," and followed by the report "Debt or Future" in 1996 prepared by a Kingdom committee chaired by the late Emile van Lennep. In addition, the commission "National Recovery Plan," better known as the "Commission of Wise Men," paid attention to the debt problem in its report issued in 1999. The latest report on the debt issue appeared in 2003, prepared by a debt committee that I chaired.

Much has been achieved since these reports were issued. But more is still needed to achieve broadly shared prosperity. Widespread poverty still stands in sharp contrast with the enormous potential of this country. Therefore, I believe that this seminar is quite timely. Now is the time to seize the opportunities and pave the way for sustained growth and rising the standards of living for all. Consolidating and extending reforms requires ambition and perseverance. Evidence tells us that the pursuit of market-oriented policies, that is, fostering competition and

innovation, remains the best path toward economic and social progress. But experience also teaches us that markets alone without regard to the social issues are no panacea. It is not an issue of choosing between market and State, but as the Mexican President Fox has put it: "...We need more market and better State."

Irrespective of the path we choose to reach our potential, sound public finances is indispensable for sustained growth, job creation, and social progress. I am indeed concerned that our high level of debt can still imperil what has been achieved. Fiscal discipline is needed not only for macroeconomic stability, but also to preserve space for essential public investment, especially in education, infrastructure, and social safety nets. I am aware that there are pressing needs that must be tackled. But I also have to say that there are no magic formulas, and governments have to make tough choices.

Ladies and gentlemen, this brings me to the main topic of my address this morning—namely, our unsustainable level of public debt. I would suggest that the three main causes of our high level of debt are: external shocks, lack of fiscal discipline, and external pressure.

The Netherlands Antilles has a very small and open economy, which is by definition highly susceptible to external shocks. Since the 1980s, we have incurred some major shocks, including the repeal of the withholding tax in the United States, which caused a major reduction in activities in the international financial services industry; a sharp devaluation of the Bolivar, which ended shopping tourism from Venezuela in Curacao; the closing of the refinery in Curacao by Shell, various destructive hurricanes in the Windward Islands, and the phasing-out of trade privileges with the European Union. The combined impact of these shocks has been estimated at 20-25% of GDP.

The authorities have developed various adjustment programs in cooperation with private consultants as well as the World Bank, and the IMF, to turn around the rising deficit and debt levels resulting from these shocks. However, incomplete and/or delay in the implementation of the programs, lack of fiscal discipline, and changing political winds resulted in the derailment of the program, and the necessary external support remained at bay. The lack of support has led to rising debt, lackluster growth and increasing marginalization. A situation resulting in a deterioration of public support for the adjustment program and weakened resolve by the authorities to continue on the path of reforms.

External pressure also contributed to the current debt problem. One of the recommendations of the World Bank study in 1986 was for the Netherlands Antilles government to pursue policies to encourage the repatriation of foreign investments of Antillean residents by issuing bonds with attractive returns. This policy was aimed at financing the budget deficits resulting from the reduction in tax revenue as a consequence of the decline in offshore activities.

This recommendation, supported by the Dutch government, provided Antillean authorities with the justification to finance themselves out of the deficits.

The result of this policy recommendation has been a debt buildup to date of close to NAf. 5 billion. If we take a closer look at the developments of this debt over the last 20 years, we can say the following:

- The total public debt increased more than four-fold-- from NAf 1.1 billion to NAf 4.7 billion.
- The debt ratio increased from 48% to 84% of GDP.
- The domestic debt component rose from 51% to 85%.
- The interest-bearing part of the debt increased from 72% to 90%.
- The interest burden of the debt increased more than six-fold-- from NAf 44 million to NAf 280 million; the share of tax revenues absorbed by interest payments rose from 5% to 23%; and the share of interest payments in total expenditures increased from 4% to 16%.

These figures are quite impressive and they illustrate clearly the size and magnitude of our debt problem. However, some further explanation of these figures is in order. First, those who have read our latest annual report before this presentation may have noticed that the current June 2005 debt ratio of 84% is considerably lower than the 96% at the end of 2004. This difference resulted from the use of the new GDP series of the CBS, compiled according to the 1993 System of National Accounts. This change in calculation resulted in an average increase in GDP of NAf 450 million annually, contributing to a

9 percentage points decline in the debt ratio in 2004. While this decrease is significant, it does not make our debt problem anymore sustainable. The level of our outstanding debt remains a cause for concern. Based on an IMF study, the Debt Committee estimated a sustainable debt ratio for the Netherlands Antilles on the order of magnitude of 40% - 50% of GDP. This ratio is about half the current value.

Second, our domestic debt component has increased to 85%, illustrating that our debt problem is primarily a domestic one. This situation contrasts sharply with most indebted countries in the world that have been coping with a foreign debt problem. Moreover, 96% of the current Antillean foreign debt is owed to the Netherlands as a result of development aid provided partly in the form of soft loans in the past, budget support, and payment arrears. So, our "real" foreign debt – due to creditors outside the Kingdom – is, in fact, negligible.

Third, the increase in the interest-bearing part of the debt resulted from the change in composition from largely concessional debt to the Netherlands to primarily local debt at market-based interest rates. The increasing interest-bearing component can be explained by the formalization of payment arrears to the government pension fund, APNA, and the social security bank, SVB. While these formalizations resulted in a higher interest burden for the government, they were necessary to prevent a further weakening of the financial position of these public institutions.

Finally, the continued rise in the interest burden caused by the rapid accumulation of debt is exerting increasing pressure on the government budget. As a result, the room for discretionary spending is declining, which is a major hindrance for the funding of essential public investment, especially for education, infrastructure, and social safety nets. The longer this process continues the more difficult and expensive it becomes to reverse. Therefore, action is urgently needed, but our social-economic and fiscal problems have reached proportions that can no longer be solved without a credible strategy to reduce our outstanding public debt to sustainable levels

If we are to achieve a balanced budget in 2010, for example, additional measures have to be taken to generate an accumulated NAf 450 million in 5 years. This figure corresponds with average additional savings of NAf 90 million per year. Even with bold and far-reaching austerity measures, the debt ratio will grow further to 90% of GDP in 2007 before it starts to decline, reaching 86% in 2010.

Given our already high tax burden and the diminishing marginal return of actions to improve compliance, there will not be much room for raising more revenues except from higher economic growth. Although, in my opinion, there is still room for further savings on the expenditure side of the budget, these savings will not generate NAf 90 million annually. Without a commensurate increase in income, our welfare will surely continue to decline.

Fiscal consolidation alone therefore will not go far enough to reach our fiscal goals of a balanced budget and certainly not within the context of the Millennium Development Goal. Swifter and bolder actions are needed to achieve those goals. As I already mentioned, the current talks regarding our future constitutional arrangements provide a unique opportunity to pave the way for sustained growth and rising standards of living for all.

Ladies and gentlemen, to complement the MDG, the European Union leaders at their summit in June this year proposed to double the EU bloc's aid over the next decade. The Group of Eight's proposal for debt relief was also recently accepted. Therefore, it is fitting to state that if the Kingdom is to rid itself of the debt problem and, hence, poverty in the Caribbean part, then consistent with its stance in the EU and Group of Eight proposal the Kingdom must consider, some debt relief. To realize these objectives, I shall present a proposal for broad debt relief.

Before I go into more detail, however, allow me to shed some light on a complicating factor in the whole debt issue, namely the upcoming constitutional changes. Although the discussions on the future constitutional structure of the Kingdom have just started, the results of the referenda on the islands leave no doubts about the direction of the changes.

Curacao and St. Maarten chose for more autonomy, Bonaire, and Saba opted for more direct ties with the Netherlands while Statia opted for the current status. The role of the central government in this constellation will at best be small or may even disappear. This issue was also raised by the "Commission of Wise Men," which stated that the central government bureaucracy had created a wasteful duplication of tasks and become prohibitively expensive. Apart from issues like the distribution of assets and liabilities and the transfer of tasks and staff, the central government debt poses serious problems both for the viability of future constitutional arrangements as well for the further development of our capital market, and hence, our investment climate.

One could reason that the central government debt should be distributed among the various islands because they all benefited from the expenditures financed by this debt. To see what a distribution of the central government debt would imply, let us assume the following: (i) let us separate those components of the central government debt that can be uniquely allocated to the islands, such as the formalization of payment arrears of the specific islands to the APNA and the SVB, and Curacao's share in the development aid loans by the Netherlands; (ii) let us distribute the remaining development aid loans among the other islands based on their relative share in the spending on development projects; and (iii) let us distribute the unallocated domestic loans based on each islands' shares in GDP. Worth mentioning is that a distribution based on the shares in total population gives a similar result.

At the end of 2004, the central government's debt amounted to NAf 2.4 billion comprising 44% of the total unconsolidated debt of the Netherlands Antilles. Based on the criteria mentioned earlier, 62% of this debt would be allocated to Curacao, 23% to St. Maarten, 10% to Bonaire, 3% to Statia, and 2% to Saba. This distribution will result in a drastic deterioration of the debt ratios of the islands. Curacao's debt ratio will increase from 65% of GDP to 102%, St. Maarten's from 18% to 76%, Bonaire's from 44% to 127%, Statia's from 11% to 71 %, and Saba's from 52% to 204%.

Since the debt ratio of most of the islands is already unsustainable, the situation becomes daunting after the distribution of the central government debt. Clearly, this outlook will cast a dark shadow on the viability of any future constitutional arrangement. Distribution of this debt without the prior consent of the creditors may also inflict serious credibility problems on the government and may hamper the further development of the government bonds' market.

Therefore, I would like to propose the following seven point debt relief plan for the Netherlands Antilles.

1. The Netherlands will take over the entire debt of the Netherlands Antilles through the establishment of a special foundation.
2. The debt will be refinanced by the Netherlands under more favorable conditions as it matures.
3. The Netherlands Antilles will forgo the annual funds provided by the Netherlands for the financing of development projects.
4. The funds that become available will be transferred to the special foundation to service the debt that has been taken over.
5. The authority of Curacao and St. Maarten to borrow, will be eliminated while they will be legally bound to balanced budgets.
6. A budget chamber will be established to safeguard the integrity of the budgetary process (i.e., preparation, compilation, and implementation of the islands' budgets according to the budget legislation and rules).
7. The establishment and functioning of the special foundation and the budget chamber will be anchored in a Kingdom's act.

If carried out, this proposal will go a long way toward creating real prospects for a balanced budget and for the successful introduction of budgetary discipline, because the islands get a chance to start with a clean slate. The elimination of the debt will help the islands escape the heavy interest burden. As a result, the projected deficit will be eliminated since the islands budgets already have equilibrium on the primary balance.

Once the Antillean debt has been taken over, it must be managed in a way that is conducive to the further development of our local capital market. This will provide the authorities with the opportunities to pursue sound economic policies to create alternative investments opportunities because the debt will be either refinanced or retired as they become due.

In exchange for the debt relief financed by the Dutch government, the Netherlands Antilles should be prepared to forego the annual Dutch aid available for development projects as its contribution to the costs incurred. This aid amounts to approximately NAf 170 million annually.

The net financial impact for the Netherlands Antilles remains positive, however, because of the elimination of the interest burden of approximately NAf 300 million. Moreover, the cancellation of development aid supports the desire of Curacao and St. Maarten for more autonomy because it reduces their dependency on aid. I want to note here that, this proposal does not imply that we will not or cannot receive any development aid from the Netherlands in the future. However, such aid will be of an incidental nature for specific projects and/or in case of natural disasters, external shocks, or periods of severe crises.

The elimination of the debt must be accompanied by several safeguards to prevent a new build-up of debts to unsustainable proportions. First, the authority to borrow by the island governments of Curacao and St. Maarten should be eliminated except for extraordinary situations. The current account of the budget should be at least in equilibrium, also known as the "golden rule of financing." During the fiscal year, revenues as well as expenditures fluctuate. These fluctuations can cause temporary cash deficits. Therefore, within certain limits, current account overdrafts may be allowed if available cash is insufficient. However, the outstanding balance must be cleared at the end of the fiscal year. Capital expenditures should be financed in the first instance by surpluses on the current account of the budget. If these surpluses are insufficient, borrowing is allowed but under strict conditions. For example, the projects financed would have to raise enough future revenues to at least cover interest payments and redemption of the loan.

Second, the entire budgetary process will be monitored by an independent budget chamber. Currently, fiscal discipline is weak, reflected by substantial annual budget overruns, loose adherence to budgetary legislation and rules, incomplete draft budgets presented to Parliament, and the absence of a multi-annual budgetary framework. To foster a durable turnaround to strict fiscal discipline, legislation must be effectuated that determines norms for budgetary variables, such as deficits, financing, and inter-budgetary compensations. Noncompliance with the legal norms should be penalized. The budget chamber will monitor the entire budgetary cycle from the preparation of the annual budget until the timely reporting of its realization. Deviations from legislation, rules, budgetary objectives and targets will be reported to the governments as well as to the parliaments according to a predetermined schedule. The governments are obliged to correct the reported deviations within an agreed upon period. I am convinced that this approach provides sufficient safeguards to prevent a new derailment of our public finances in the future.

A joint Working Group has been established to assist and advise the governments in the discussions leading toward the Round Table conference about a debt relief proposal. Preliminary discussions with this Working Group have already taken place and details are being worked out on a technical level. This work will result in the presentation of different scenarios of debt relief to be put on the agenda of the Round Table negotiations on the new constitutional relations in the Kingdom. Assuming that the debt relief will be effectuated at the earliest in 2006, it is important that the 2006 budget of the combined governments show at the minimum an equilibrium on the primary balance. However, a primary surplus would be preferable to create financial room to address our social issues.

Ladies and gentlemen, I have reviewed briefly the development of our government debt to unsustainable proportions and the main causes of this development. The resulting rise in the interest burden has crowded out the discretionary spending capacity of the government with detrimental effects in policy areas that determine our welfare, such as support for the poor and elderly, education, public health, public safety, and infrastructure. The sacrifices necessary for fiscal consolidation within a reasonable period of time are so large, that they cannot realistically be carried without external assistance. Moreover, the austerity measures required would contribute to a further deterioration of our welfare. In addition, the upcoming constitutional changes complicate matters because the elimination of the central government will, in principle, lead to a redistribution of its debt among the islands. The resulting rise in the debt and interest burden of each island will be an obstacle to the successful introduction of a new constitutional structure.

Since our debt problems cast such a huge shadow on our constitutional future and our welfare, I have proposed an ambitious debt relief plan. This plan is designed so that it will provide a unique opportunity to re-establish fiscal discipline in the public finances of the Netherlands Antilles, free up resources to address our social needs, provide a basis to pursue a growth oriented economic strategy and at the same time introduce the necessary constitutional changes to eliminate the gridlock in the government of the Netherlands Antilles. This proposal also will not impose any undue budgetary burden on the Dutch government. Aside from re-allocating the development aid funds toward the debt servicing, part of the windfall gain resulting from the recent upward revision of the Dutch GDP figures should be considered.[2] The plan is consistent with the position that the Dutch has taken both in the EU Summit and internationally.

For this proposal to be successful it must be swiftly accepted and implemented. We know all too well that the “pas de deux” formula or the “carrot and stick” approach adopted before caused us to loose momentum even when draconian measures such as the “macthingingswet”, were used. We therefore, have to seize the moment and pave the way for sustainable growth and rising standards of living for us all. In turn, the islands must be prepared to anchor this proposal in a Kingdom act to provide the financing party with the assurance that the progress achieved will not be rolled back.

Ladies and gentlemen, this proposal is a necessary condition for the rising economic tide. But to be sufficient, we must continue to focus on structural measures, sound economic policies to create an environment friendly to investment and business and remove our trade barriers to provide the necessary base for us to grow out of poverty. I am convinced that with this solution of our debt problem, which can be characterized as shared responsibilities, the islands of the Netherlands Antilles will be given a fair chance to work out their new constitutional status with the ultimate goal of improving the welfare of their citizens.

Thank you for your attention!!!

[1] The first MDG is to halve the percentage of people living in extreme poverty, defined as less than US\$1.00 a day will be achieved by 2015.

[2] Recently the Dutch GDP figures have been revised upward. Given the longstanding Dutch policy of allocating .8% of their GDP to development aid, this upward revision represents a windfall gain for development assistance. Part of this increase may be used for debt relief

within the Kingdom.