On core tasks and fiscal situation under the new constitutional status. With special attention to the new country of St. Maarten.

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1. Introduction.

Ladies and gentlemen, I would like to take this opportunity to congratulate the office of “Hassink and Roos” on the celebration of their first lustrum on St. Maarten. In addition, it is also a great pleasure for me to be here in St.Maarten again and to participate in this seminar entitled “The New tax System for the Country Sint Maarten”.

During the last three years, I have been part of many efforts being undertaken to set up and recommend alternative public organizations, structures, and processes for the new countries within the Kingdom and the BES islands. Just this morning, for example, the Committee on the Distribution of Assets and Liabilities, of which I am the chairperson, concluded a great part of the work that we have been conducting during the last 24 months. The Committee was charged with assessing, valuing, and distributing the assets and liabilities of the Netherlands Antilles as per December 2005. Actually, the first draft balance sheet is now complete.

It is far from easy to synchronize all these efforts because of the many challenges and difficulties that lie ahead. It becomes almost an impossible mission when you have to deal with dismantling of the country of the Netherlands Antilles while at the same time working on the new countries and new relationships between the islands.

When performing my various duties with respect to the reorganization of the Netherlands Antilles and knowing the many things that we still have to complete, a few things have crossed my mind. I consider it my duty to share these concerns with you. What will happen to the people working in the various organizations and agencies after the dismantling of the Central Government? Can they all find meaningful work in the new countries? How will the new entities function if no adequate and reliable financial control systems are in place or if the needed manpower is lacking on the various islands? Will the new entities in the future become too heavily dependent on the consultancy firms in order to comply with the heavy financial reporting burden that will be put on them?

Despite all of the difficulties and concerns I am voicing here, I must admit that, as technicians, we are now passing through the most exciting and gratifying time in the public sector on our islands. The positive side of the involvement in many study groups and committees in the public sector is that there is no better time to learn quickly. I have gained great in-depth knowledge about the government operation and public administration of the various islands in a relatively short time.

The dismantling process and the creation of new countries have brought many people from the various islands together to work and share the best of their knowledge and potential to complete various difficult exercises. This new momentum has given many of us the opportunity to work and discuss together the many challenges and also the threats that the new status will bring. My own experience in this entire exercise has been that we have dealt with many problems and also have shared our views on many issues that have kept us divided for so long. Up to now, we have been successful in resolving many of the difficult issues, and in the end, that is the most important purpose for our working together.

Today I want to share with you some fascinating data that I have found from an international investigation on the public sector expenditure, revenue, and debt situations for “smaller” vs. “larger” countries. The conclusions of this analysis will give us a benchmark to appraise the position of the new country of St. Maarten. Consequently, we will compare the study’s conclusions with the current situation for the country of St.Maarten. What are the lessons to be drawn from this international comparison?

In closing, I will review some of the possible core tasks that the new country of St. Maarten will have to assume starting in 2009.

2. What is the role of the public sector?

The public sector consists of the social and economic systems within a country that are mainly focused on the delivery of goods and services by and for the government. From economic theory, we learn that goods and services provided through the government-- the so-called public goods-- cannot be provided efficiently by market intervention. Therefore, it is the obligation of the government to assure that the public is not deprived of these goods and services. Some typical examples of these public goods are national security, police services, and design of a country's legislation and regulations..

One of the important characteristics of public goods is that the entire community enjoys the benefits of the public goods/services being provided but is not willing to pay for these goods. This is the case because these are "non-rival consumption" and "non-excludable" goods. That is, the consumption of the good by one individual does not reduce the amount of the good available for consumption by others, and no one can be excluded from the use of these goods. Therefore, governments under normal circumstances levy taxes and other charges to finance the spending on public goods and services.

The classical and crucial question to answer here is:

How far should the government go with the provision of public goods and services without saddling the community with an excessively high tax burden and/or other "forced" and elevated public contributions from the consumers, the producers, and the business community?

The most straightforward answer to this question is :

If the community prefers that the government impose the lowest possible taxes, then this can only be achieved if the community is willing to accept that the government can provide only the bare minimum of public goods and services.

This view of taxation is that taxes are intended to generate revenue for the government to spend on roads, schools and hospitals, and on more indirect government functions like good regulation or justice systems. According to this view, taxation has a fiscal purpose.

There are alternative views of the purpose of taxation. For example, taxation can also be used to achieve other goals such as the distribution of income, that is, the transferring of wealth from the richer sections of society to poorer sections. Another goal of taxation can be as a repricing mehcanism. That is, taxes are levied to address externalities; tobacco is taxed, for example, to discourage smoking. But these two alternative functions of taxation will not be the main focus of my analysis today.

Let us now turn to the results of the international investigation that I referred to in my introduction.

3. What are the lessons for smaller economies with respect to public sector spending, revenue, and debt?

When Martin Hassink asked me a few weeks ago if I would be willing to do one of the presentations during this workshop, I almost instantly accepted the invitation before knowing what precisely Martin was expecting from me.

In the days that followed, while doing an investigation in the Bank, I came across an interesting Working Paper of the International Monetary Fund (IMF) entitled, "Big Government, High Debt, and Fiscal Adjustments in Small States." The paper, published in February 2008, was written by Stephanie Medina Cas and Rui Ota .

After reading and evaluating this working paper and after reviewing its interesting conclusions, I reflected that this would be one of the topics I could share with you today. By comparing these findings in the international market with the possible scenario for the new country of St. Maarten, I realized that I could set the stage for the benchmarking exercise of public finances for 2009 and beyond. In addition, I decided to propose a possible organizational structure for the new country of St. Maarten.

Let me take a few minutes to run quickly through the most essential findings of this study and use these as an opening point or a benchmark on our journey through the process and challenges that will face the country of St. Maarten, recognizing that the exercise can also easily be translated for Curacao and the BES islands in the immediate future.

The IMF working paper starts with the conclusions of other IMF studies done in the 1990s and early 2000 that point out that "small states" face higher per capita costs because they have limited economies of scale, which leads to an inverse relation between the country size and the size of the government. To say it in popular terms: smaller countries tend to have bigger governments. Why is that so? Well, according to the IMF study:

"Small states are more open, have a higher reliance on international trade and capital flows and are more open to external shocks and may therefore require a bigger government to insulate their economies from these external shocks".

Recall the situation of the public finances and the state of the economy of the islands after the hurricanes stroked the islands including St. Maarten in the mid-1990s. A more recent event is the higher oil prices of over 100 dollars per barrel that are affecting spending power through higher import prices, thereby reducing the economic growth perspective for the world economy.

Since the early 1990s, many small states also are incurring a growing public debt that has affected their economic potentials. Investigations have shown that a high public debt coincides with marginal economic growth rates (refer to figure 10.1).

I would like to sum up the three most important conclusions of the IMF working paper, which as I noted earlier, is titled " Big Government, High Debt and Fiscal Adjustments in Small States" because I believe that St. Maarten, Curacao, and the BES islands will have to take these conclusions into consideration when moving ahead with the new constitutional changes within the Dutch Kingdom. After I list the three conclusions, I will provide more specific findings about each. Number 1: small states tend to have bigger governments and higher public expenditures and taxes. Number 2: small states are more vulnerable to external shocks. And number 3: growing public debt has had negative effects on the economic growth in these smaller economies.

The IMF study was conducted during the period 1990-2004 in 42 countries (including some smaller islands in our region). The countries covered included both developing and emerging market economies. A small country is defined in the study as a country with a population of about 2 million or less.

Now let us turn to some of the more specific findings of this study.

Smaller countries have a tendency to have bigger governments than larger countries when measured by both total expenditures as well as other important expenditure categories such as "wages and salaries," "goods and services," and "grants".

According to the IMF study, the average total expenditures of smaller countries fluctuated in the range of 35-40% of GDP while in larger countries the results were in the range of 25-30% of GDP. The current expenditures as % of GDP were over 25% in smaller countries whereas in larger countries, the current expenditures ranged between 18-25% of GDP.

For the expenditure category "wages and salaries," smaller countries on average have been spending about 11% of GDP. In the category of "goods and services," smaller countries spent about 8% of GDP. In contrast, larger countries spent an average of 8% of GDP on "wages and salaries," and 4% of their GDP on "good and services."

The study also found that higher overall expenditures in smaller countries result in higher taxation and other revenues for the government to finance these higher expenditures. If the revenue continues to lag behind the public spending, the country will sustain growing public debt. And this study has also shown that mounting public debt in the end will result in lower or marginal economic growth.

On the revenue side, smaller countries tend to have total revenues between 25-30% of their GDP while in larger countries, the revenue as % of GDP is between 22-25% of GDP.

To set the stage for further discussions, I have analyzed the results for Aruba, which as you know, has had a country status within the Kingdom since 1986. My own comparison of the Aruba data with the results of the IMF study for smaller countries found that on most of the expenditures categories as % of GDP, the score of Aruba is comparable with those in the IMF study. For example, the labor costs in the public sector as % of GDP were on average 12.1% in Aruba (from 2000- 2008), slightly higher than the average of 11% for the smaller countries (from 1990-2004). The current expenditures in Aruba were on average 23.8 % (from 2000-2008), slightly lower than the elevated levels of over 25% of GDP in the smaller countries in the study.

The significant differences for Aruba were on the revenue side--their revenues as % of GDP were 22.7%, lower than the average of the smaller countries in the IMF study, which ranged between 25-30%.

To illustrate this point further, I can refer to Article IV of the IMF report for Aruba that was released in February 2008. On page 13 of that report, a comparison is given between Aruba's tax revenue of 20.1% of GDP (for the period 2004-2006) and the same data for the Caribbean region, which was 23.9%.

If Aruba's authorities prefer to have on average a relatively low public sector revenue, then the authorities actually have two options: (1) either provide the community with public goods and services only at a level of what is generated in public revenue. Or (2), allow the government to spend more than it receives, an approach that will inevitably result in increasing public debt. I will come back to this point later.

With the conclusions of this international study and a short reference to some public finance data for Aruba, we are now better equipped to look at the situation in St.Maarten now and in the future. If we consider the results of the IMF study to be an objective yardstick, then we can start from there and use the data for the new country of St.Maarten to analyze and benchmark the new country's probable future situation.

4. The core task of and the fiscal benchmarks for the new country of St.Maarten

This afternoon we have been discussing various aspects regarding the building of a new country, and we have concluded that this is not an easy task. Let me now focus on the possible organization of the new country of St.Maarten, drawing from my experience at the Central Government level in Curacao, and recently also for Bonaire, Statia, and Saba (BES islands) with public sector organizations and as a member of the Committee of Financial Supervision .

The first question that the authorities should concentrate on when contemplating a new design of the government organization is: which tasks will this new government assume starting in 2009? From that starting point, a new government organization should be set up or at least a well- thought out plan will have to be constructed that will include the number of departments and ministries that will be needed under the new status and the formation necessary to run the various departments.

Let us first start on the core tasks that the new country will be assuming. Some of these tasks are now being (partly) done by the Central Government and, therefore, it is to be expected that the new country of St. Maarten will have to take over these tasks from the Central Government. My starting point for a new organization is the functional classification that the governments use when preparing their annual budgets. I have concluded that at least the following tasks will become the full responsibility of the country of St. Maarten after 2008.

1. Heath Care and Social Affairs
2. Finance and Fiscal Affairs
3. Economic Affairs (and Tourism)
4. Labor Relations
5. Traffic and Transportation
6. Education, Sports and Culture
7. Justice and Police
8. General Affairs
9. Domestic Affairs and Legislative Matters

Assuming that National Security will continue to be the prime responsibility of the Kingdom government after the dismantling of the Netherlands Antilles, we are left with the abovementioned tasks for the new countries of St.Maarten and Curacao.

Figure 3 shows a possible scenario for the organization of the public sector responsibilities here in St. Maarten. For practical and efficiency reasons, I have combined the 9 main core tasks of the government that we have just discussed into 6 (six) organizational departments.

For comparison purposes, I verified the organization of the country of Aruba; Aruba has 7 government departments. Given that Aruba has a larger economy (GDP is ± 3 times that of St. Maarten), I think the organization as illustrated below can be considered a fair and realistic starting point for the country of St. Maarten.

Figure 3. A possible organizational chart for the country of St. Maarten

With these ministries and given the complexity of the problems facing the country of St. Maarten and the population of the island, I'm convinced that this structure will work for the coming years and will serve the island well, particularly given that knowledge and experience suggest that the best way to set up a government apparatus is to start in the early stages of development with a small government body. With the passing of time and after more experience is gained in managing this apparatus, the structure can be modified if desired or necessary.

Let us now turn to the numbers and figures from the IMF study and calculate the maximum expenses for wages & salaries, goods & services, expenditures and revenue for the country of St. Maarten.

Table 1. Benchmarks from IMF study for country of St. Maarten (GDP in 2007 is ± 1200 million guilders)

	IMF Results for "smaller countries" in % GDP	**Benchmarks for country of St. Maarten**	**Projected actual for St. Maarten**	**Projected actual in % GDP**
Wages & Saleries	11%	132 mln	130-145 mln	10.8 - 12.1%
Goods & Services	8%	96 mln	87-93 mln	7.3 - 7.7%
Total Expenditures	35-40%	420-480 mln	322-343 mln	26.8 - 28.5%

Total Revenues	25-30%	300-360 mln	311.6 mln	25.9%

The projections and calculations on spending and revenue for the country of St.Maarten were performed based on the following assumptions. After dismantling the Netherlands Antilles, all of the tasks at the Central level will have to be transferred to the BES islands and the countries of Curacao and St. Maarten; thus, most of the expenditures starting in 2009 should be included in the budgets of the islands. On the expenditure side, I have taken the share of the GDP of St.Maarten now in the Netherlands Antilles (19%) as the distribution key of the total expenditures of the Netherlands Antilles after corrections for the interest payments and transfers (scenario 1). And the other calculation was based on a 25% share of St. Maarten in Central Government expenditures after correction.

To calculate the revenues for the country of St. Maarten, I have added the base revenue that the island of St. Maarten is generating now with the revenue from the Turnover Tax, special customs duties, and economic levies, the transfer taxes. This resulted in total revenue for 2007 of 311.6 million, which is in the lower boundaries of the range of 300- 360 million that would be normal for ‘smaller countries’ according to the IMF study. In % GDP, this means that total revenue as % GDP for “smaller countries” should be 25 – 30% while the country of St. Maarten will probably score 25.9%.

On the expenditure side, the total expenditures according to the IMF investigation for “smaller countries” should be in the range of 420- 480 million (35-40% of GDP). For the new country of St. Maarten, this would range between 322-343 million guilders or 26.8% -28.5% of GDP. Comparing this result with the IMF benchmarks, St. Maarten as the new country in the Dutch Kingdom is projected to have significantly lower total expenditures.

One important category of the public spending is that of wages & salaries. After dismantling the Netherlands Antilles, the new country of St. Maarten would have a wage bill ranging between 130-145 million guilders or 10.8-12.1% of GDP. In the upper range of the projection, the wages & salaries in St. Maarten will be slightly higher than expected. However, the results are consistent with what Aruba has at this moment, and, therefore, this gives realistic projections for this expenditure category.

For the other public spending category of goods & services, the projections for the new St. Maarten would be consistent with the IMF investigations for smaller countries.

Finally, I want now to share with you some projections for public debt of the country of St.Maarten. For this, I have to use one important element of the approved final accord of 2006 between the islands of the Netherlands Antilles and the Netherlands.

The interest standard or the so-called “rentelast norm” for the years 2005-2007 is one important factor to use to determine the maximum debt that the new countries of St. Maarten and Curacao can incur. In my calculations, I have used the data of the revenue calculated above for the new country of St. Maarten and calculated the maximum of 5% of the average revenue of 3 years to determine the “rentelast norm” for St. Maarten. The projection is approximately 13 million guilders.

From this “rentelast norm,” one can resolve what the maximum public debt for the island of St. Maarten will be. Using the following formula (1) and assuming that the new country of St. Maarten can borrow at 6% in the financial market in future:

(1) Capital market interest rate x (maximum) public debt = “rentelast norm”.

(2) 6% x (maximum) public debt = 13 million.

(3) Maximum public debt = 13 million / 6%

(4) Maximum public debt = 217 million.

And this public debt as % of GDP for the year 2007 can be calculated as approximately 18% of GDP (217 mln./ 1200 mln).

According to international standards, this figure is a safe starting point for the country of St. Maarten. I would not be fair with you, however, if I don't give a forewarning at this stage. And I again use my experience with the work that I did on the Debt Commission for the Netherlands Antilles and Aruba in 1996 (the so-called van Lennep Commission). In 1996, the Kingdom Government together with the governments of the Netherlands Antilles and Aruba established a working group under the chairmanship of Dutch minister of State, the late Mr. E.van Lennep, to determine the characteristics and the level of the public debt of the Netherlands Antilles and Aruba.

Again using Aruba as a reference point for this analysis of St. Maarten, I can show you how the public debt for Aruba has developed since 1996. In 1996, after completing the committee work for Aruba, that island had a public debt ratio of 29% of GDP, a percentage that was manageable and reasonable for that time. Today, the public debt ratio of Aruba has reached 45% of GDP. This steady increase of the public debt ratio of 1.5% per year was fueled mainly by budget deficits as % of GDP of around 2.9% (averages for 2003-2007 IMF[1]). This frail result for Aruba's public debt was recorded despite the positive economic growth of 2.1% (averages for 2003-2007 IMF [2]). Economic expansion has thus not safeguarded Aruba from incurring more deficits in the public sector and consequently a growing public debt ratio. I want to again refresh your memory of what I said in the beginning of my presentation:

> *Smaller countries tend to have a bigger government and I can add to that statement that this will probably happen despite strong economic performance.*
> *Higher financial deficits in the public sector will adversely affect economic growth in the long run.*
> *Government apparatus is used for most of our islands to capture*

5. Concluding remarks and recommendations

I can imagine that you are probably puzzled and somewhat exhausted by the many numbers, ratios, and comparisons that I have presented to you today. My main goal was not to give you a simple course in mathematics, but rather, to give you a clear and objective picture of what the country of St. Maarten might look like or turn out to be in the coming years. There are many positive signs for the island's new status, but I have also given you some clear challenges that the island should work on to overcome difficulties it will face.

Let me repeat some of the positive things with respect to St. Maarten. These include the sound and solid economic expansion, a public debt ratio that at the outset looks promising, expenditure and revenue as % of GDP that are comparable with the IMF's study of smaller countries. Also the spending categories wages & salaries and goods & services are projected to be in line with the international benchmark. So far, so good!!

But I have also indicated that it is important that from the outset, a solid and professional government organization and civil servant apparatus is in place. Another word of warning that I offered was related to the public debt ratio that could gradually increase over time despite the excellent starting point, and I have referred to the data of Aruba as an example. Strong economic growth has not guaranteed a sound public management there. In our projections for the new country of St. Maarten, the total expenditures as % of GDP will be in the range of 26.8% -28.5 %, slightly higher than the total revenue as 25.9% GDP. In time, the public debt will increase. Again this is consistent with the situation that we have seen in Aruba.

The last point of concern is to see how the island can organize the smallest possible government staff able to work efficiently and become a realistic sparring partner for public authorities and the government of the island in future. An important thing is that as civil servants and advisors, you have to be frank and realistic in what you advise the government. Remember that sometimes bad news is not what the decisionmakers want to hear. They have a political role, while you are a technician, and that difference has to remain clear. However, my own experience is that by being honest with the government and the authorities, you will earn more respect in the long run.

One of the things that I need to mention for St. Maarten is that it took me and my colleagues many days and even weeks to obtain and collect adequate data on the public sector to do the exercise that I have just shared with you this afternoon.

If in the end, you feel uncomfortable about the data and figures that I have used today,

I'm prepared to go through the entire exercise with you again if necessary on another occasion. I want you to see this presentation as a truly and legitimate exercise on my part to trigger the authorities of the island together with those involved in the consultative work for the government to think about and review these data in order to start with a sound country.

I wish you all the best in the future.

Thank you.

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[1] Statistical section of the IMF article IV consultation for Aruba in February 2008.

[2] Statistical section of the IMF article IV consultation for Aruba in February 2008.