SM/08/23
Correction 1

July 1, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Antigua and Barbuda—Staff Report for the 2007 Article IV Consultation**

The attached corrections to SM/08/23 (1/18/08) have been provided by the staff:

**Factual Errors Not Affecting the Presentation of Staff's Analysis or Views**

**Page 5, line 1:** for "(including the new Financial Administrative Act"
read "(including the new Financial Administration Act"

**Page 6, para. 12, first bullet, line 4:** for "There are concerns,"
read "The staff expressed concerns,"

**Page 8, para. 16, line 5**: for "The mission underscored the need to fully implement the new Finance Administration Act,"
read "The mission underscored the need to fully implement the regulations associated with the new Finance Administration Act,"

**Page 13, Box 1, para. 1, line 1:** for "The United People's Party,"
read "The United Progressive Party,"
**second bullet, line 1:** for "The program received some 1,000 applicants"
read "The program received over 1,000 applicants"
**third bullet, lines 1 and 2:** for "The Finance, Administration and Audit Act was passed by Parliament in November 2006, and expected to be implemented with the 2008 budget."
read "The Finance Administration Act was passed by Parliament in November 2006, and implementation began with the 2008 budget."

**Page 36, line 3:** for "Notwithstanding the fiscal imbalances, the authorities have continued to rollover debt on the regional government securities market at relatively low rates."
read "Notwithstanding the fiscal imbalances, the authorities have continued to re-issue debt on the regional government securities market at relatively low rates."

Questions may be referred to Mr. Meredith (ext. 38534) and Mr. Nassar (ext. 38665) in WHD.

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already been taken (including the new Financial ~~Administrative~~ Administration Act and the partial rollout of the FreeBalance software), much more remains to be done to effectively contain public spending and rein in the accumulation of arrears.

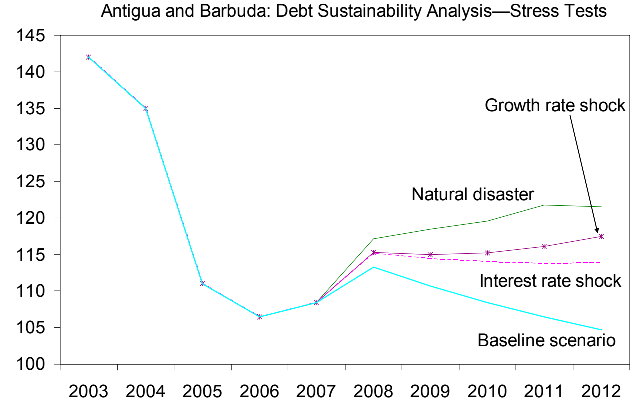
## A. Restoring Fiscal Sustainability

9. **Achieving a primary fiscal surplus in 2008 is a key challenge**. According to the authorities, the limited progress to date in improving fiscal positions was partly due to delays in enacting reforms, weaknesses in tax administration, and temporary expenditure spikes. The mission emphasized the need to show significant progress in fiscal consolidation in 2008, based on the measures already implemented. The authorities agreed with staff that, as one-off expenditure increases in 2006–07 are phased out (mainly the voluntary separation program and CWC-related capital spending), such an outcome is achievable if the government firmly controls spending and stays the course with tax reforms.

10. **Staff encouraged the authorities to adopt a formal budget proposal for 2008 that is consistent with these objectives**. In the event, the authorities presented a 2008 budget to Parliament on December 3, 2007 that envisages a primary surplus of 0.7 percent of GDP, consistent with the near-term objectives discussed during the mission. Expenditure is budgeted to remain sizable, mainly in social and capital spending, financed by grants from the PetroCaribe Agreement with Venezuela (Box 2).

11. **Current policies would be consistent with a small primary surplus over the medium term, but this would not allow a significant reduction in the debt-to-GDP ratio**. Staff projections show that the medium-term primary balance would remain below 1 percent of GDP under current policies, which assume: existing tax rates; a slight decline in public investment to 4 percent of GDP; modest growth in public employment of 2½ percent per year; and real public sector wage increases of 2 percent per year. Under this scenario, debt would remain stable relative to GDP and far above the authorities' objective of reducing public debt to less than 60 percent of GDP in 2020, consistent with the ECCB benchmark. While fiscal gaps could be filled via domestic and regional sources as well as a possible debt strategy, their significant size may create pressures for further financing through arrears. The less favorable debt paths

Antigua and Barbuda: Debt Sustainability Analysis—Stress Tests




Source: Fund staff calculations.

illustrate the vulnerability of the economy to exogenous shocks, particularly natural disasters.[2]

12. **The mission emphasized that, in the medium term, additional measures are needed to achieve public debt sustainability**. To achieve the ECCB benchmark, a primary surplus of around 4 percent of GDP would be required. The mission suggested a mix of revenue and spending measures, including:

Antigua and Barbuda: Yield from Additional Measures Under the Active Scenario
(In percent of GDP)

| | Average 2009–12 |
|---|---|
| Improvement in primary balance over the baseline | 3.0 |
| Revenue gains | 1.3 |
| Unification of the VAT rate in 2009 | 0.6 |
| Yield from improved tax administration and compliance | 0.8 |
| Expenditure reductions | 1.7 |
| Wages | 0.5 |
| Employment contributions | 0.1 |
| Civil service pension reform | 0.3 |
| Transfers to public sector | 0.3 |
| Capital expenditure | 0.5 |

Source: Fund staff projections.

- V*AT (ABST) reform.* The mission welcomed implementation of the VAT, with registrations exceeding initial expectations and strong revenues likely reflecting a large informal economy that was previously untapped. ~~There are~~ The staff expressed concerns, however, about differential rates (the VAT rate for hotels is 10 percent, compared with 15 percent for other sectors)[3] and low filing rates. In addition, the compliance rate in Antigua and Barbuda is about 70 percent, compared with about 85 percent elsewhere in the region. The mission recommended strengthening tax and customs administration and moving to a uniform VAT rate of 15 percent in 2009, including on hotels. These measures are projected to raise tax revenues to about 24 percent of GDP by 2012 (close to the ECCU average). In line with staff's recommendations, the authorities announced in the 2008 Budget Speech their intention to strengthen the administration of the ABST.

- *Property tax reform.* Although the real estate sector has boomed in recent years, tax on property continues to underperform. The mission welcomed the move to a market-valuation-based property tax system in 2007 and the ongoing cadastral surveys as important first steps toward strengthening tax collection.

- *Domestic oil pricing*. While the 40 percent increase in gasoline prices in late 2005 helped restore effective tax levels, there have been no subsequent adjustments, and the budget remains vulnerable to fluctuations in world oil prices. The mission welcomed the authorities' intention to move to a full pass-through system as announced in the 2007 Budget Speech, and recommended that they do so in the

[2] The debt dynamics reflect average impact of 12 large natural disasters in the ECCU (Rasmussen, WP/04/224). Policy measures to better prepare the region for natural disasters are discussed in the *ECCU Staff Report for the 2007 Discussion on Common Policies*, SM/07/403.

[3] See Koffie Nassar, "Corporate Income Tax Competition in the Caribbean," Chapter VI of ECCU: *2007 Selected Issues*, SM/08/10.

- context of a regional initiative. In the 2008 Budget Speech, the authorities announced their intention to develop a framework for quarterly price adjustments in 2008.
- *Public expenditure management*. The mission emphasized the need to promote efficiency, accountability and transparency in government financial operations. While the Freebalance software has been installed in most ministries, it is critical that the required IT support be put in place to strengthen central monitoring and control of expenditure. This should also minimize further arrears with suppliers. Regarding relations with other public sector entities, the mission recommended that the government establish a transparent and commercial basis for dealing with the public utility company (APUA), including full payment for all utility services received.
- *Civil service reform.* The recent voluntary separation program should help contain the wage bill. However, skill shortages have emerged in certain areas, for instance in the Internal Revenue Department. The mission recommended that future retrenchment programs be targeted at areas where changing needs have made staff redundant, while redirecting resources to more productive uses. In addition, the authorities noted that rigidities in public sector employment practices inhibited the hiring and retention of qualified staff in key areas and that greater flexibility is needed to build the capacity to formulate and implement policies effectively.

Antigua and Barbuda: Size of the General Government, 2005

| Country | Government Employment (Percent of Labor Force) | Government Wages (Percent of GDP) | (Percent of Current Revenue) | (Percent of Total Expenditure) |
|---|---|---|---|---|
| ECCU countries 1/ | | | | |
| Antigua and Barbuda | 33 | 11 | 51 | 37 |
| Dominica | 13 | 13 | 40 | 33 |
| Grenada 2/ | 10 | 11 | 40 | 25 |
| St. Kitts and Nevis 2/ | 22 | 14 | 38 | 32 |
| St. Lucia 2/ | 20 | 10 | 39 | 31 |
| St. Vincent & Grens. | 11 | 14 | 47 | 38 |
| Other Caribbean | | | | |
| Barbados 1/ 3/ | 21 | 10 | 31 | 29 |
| Belize 2/ | 16 | 10 | 44 | 36 |
| Jamaica 1/ | ... | 11 | 38 | 31 |
| Trinidad and Tobago 4/ | 23 | 5 | 14 | 17 |
| Other small states 5/ | | | | |
| Mauritius | ... | 7 | 33 | 26 |
| Samoa 1/ | ... | 7 | 28 | 15 |
| Seychelles | ... | 15 | 31 | 30 |
| Tonga | ... | 11 | 42 | 44 |

Sources: World Economic Outlook; International Financial Statistics; Government Financial Statistics; and Fund staff estimates.
1/ Data for central government.
2/ Employment data as of 2002.
3/ Employment data as of 2004.
4/ Employment data includes government public service and statutory boards.
5/ Government wage data as of 2004.

## B. Debt Strategy

13. **The authorities are committed to strengthening debt management and normalizing relations with creditors**. They have started the second phase of the debt strategy with the assistance of international financial advisors. While the ultimate objective is to normalize relationships with all creditors, the immediate focus is on resolving disputed claims, regularizing arrears to statutory bodies, and preventing further accumulation of arrears. The mission supported this approach, and recommended that, if a more comprehensive restructuring is undertaken, the authorities should engage all creditors in an open and collaborative dialogue and assure the stability of the domestic financial and social security systems. A contingency plan should be designed to address a possible sudden lack of

access to regional financial markets. The capacity of the debt management unit should be strengthened, as there could be scope for reducing overall debt costs within a prudent and transparent debt management framework.

14. **Even with debt restructuring, substantial fiscal effort will be needed to achieve fiscal sustainability**. The mission noted that even with some write-off of existing debt, a strong fiscal effort would still be needed to place public debt on a sustainable path and increase the likelihood that investors would be willing to participate in future debt restructuring. The authorities generally concurred with these views, and reiterated their commitment to regularize arrears to statutory bodies and normalize relations with creditors in the framework of a medium-term debt strategy.

15. **PetroCaribe**. The PetroCaribe Agreement with Venezuela could provide significant budgetary support. The mission commended the innovative and transparent measures that had been taken to separate out the grant from the loan element of the program, while underscoring the need to ensure that PetroCaribe funds are linked to social development programs in the budget, consistent with overall fiscal objectives.

### C. Addressing Contingent Risks

16. **Coverage of fiscal accounts**. A comprehensive assessment of Antigua and Barbuda's public finances should include not only the central government, but also the broader public sector. The weakness of data on public sector activities hinders a full assessment of the fiscal position, including contingent risks to the central government. The mission underscored the need to fully implement the regulations associated with the new Financial Administration Act, which will allow the government to better monitor and control all public accounts.

17. **Pension reform**. The Social Security System (SSS) is running down its liquid assets owing to a cash deficit, reflecting the absence of government contributions to pay for the social security benefits of its employees. The authorities announced in the 2008 Budget Speech their intention to make these contributions. In addition, the government's debt to the system needs to be regularized, including from past unpaid contributions. Even with these actions, the longer-term prospects for the system are a cause for concern. The mission welcomes the ongoing actuarial review, and hopes that its findings will provide the basis for timely reform actions to forestall the need for more drastic adjustments down the road. Equally important is the need to reform civil service pensions, which currently are noncontributory and unfunded, implying a large medium-term fiscal burden.

### D. Enhancing Medium-Term Growth

18. **Medium-term growth prospects are broadly favorable, but need to be supported by structural reforms**. The unwinding of construction activity to more normal levels strengthens the case for accelerating structural reforms so as to allow the private sector to take full advantage of the increase in hotel capacity created in recent years.

**Box 1. The Government's Fiscal Objectives, Reforms, and Outcomes**

**Fiscal objectives.** The United ~~People's~~ Progressive Party, which took office for the first time in 2004, adopted an ambitious reform agenda to address fiscal imbalances and high debt. The government's fiscal targets were further elaborated in the 2006 Budget Speech, calling for: a current account surplus of 4 percent of GDP; an overall deficit of less than 3 percent of GDP in five years; and public debt of less than 60 percent of GDP by 2016. The time frame for the latter target has subsequently been extended to 2020, consistent with the objective set by the ECCB's Monetary Council in July 2006.

**Progress in reforms.** Progress has been made in implementing tax reforms and reducing the wage bill.

- *Key tax reforms.* (i) the personal income tax was reintroduced in April 2005; (ii) discretionary tax concessions were suspended in late 2005; (iii) a market-valuation-based property tax system was introduced in 2007; and (iv) a VAT was implemented in January 2007.
- *Voluntary civil service separation.* The program received ~~some~~ over 1,000 applicants (10 percent of civil service employment). Actual separations are expected to be completed by the first quarter of 2008.
- *Public expenditure reform.* The Finance~~,~~ Administration ~~and Audit~~ Act was passed by Parliament in November 2006, and ~~expected to be implemented~~ implementation began with the 2008 budget. Technical assistance is being provided by CARTAC in cash and expenditure management.
- *Social security reform.* Key issues and options were discussed at a public symposium in July 2006 and a White Paper was published in late 2006. There is no timetable for the next steps, however.

**Outcomes.** Despite these reforms, the primary fiscal deficit deteriorated from 1¼ percent of GDP in 2004 to almost 4½ percent of GDP in 2006, reflecting a number of factors:

- Implementation of the tax reform package (VAT and property tax) was delayed due to capacity constraints, implying that its full effect will not be realized until 2008; the excise tax—initially estimated to yield about 1 percent of GDP—was not implemented, and is temporarily off the table as a policy measure.
- Tax yields were affected by generous tax exemptions (under the property tax, corporate income tax and also VAT) to investment projects associated with the 2007 CWC.
- Revenue performance continues to be affected by weak tax compliance and enforcement. Customs procedures are inefficient, reflecting delays in the anticipated reform of the customs department.
- Capital outlays and transfers to public enterprises sharply increased in 2006–07, largely reflecting upgrading of public infrastructure in relation to hosting the CWC.
- Delays in implementing the civil service reform imply that the associated wage savings will not be fully realized until 2008.

**Box 2. PetroCaribe Agreement**

Under the PetroCaribe agreement, Venezuela supplies refined oil products to Antigua and Barbuda on concessional terms. Venezuela delivers the products at market prices, but 40 percent of the value—if world prices are in the range of US$50–100 per barrel—is financed at a 1 percent interest rate over 25 years.[1]

PDV Caribe, a government-owned corporation, handles all operations under PetroCaribe, and implements the authorities' guidance regarding allocating the grant element. To cover the future debt obligations to Venezuela, PDV Caribe invests in zero-coupon deposits that have the same present value as the debt obligations. At current interest rates—around 7 percent—the grant element is about 50 percent of concessional financing.

To avoid excessive dependence on a single oil supplier, the authorities limit shipments from Venezuela to about one half of total consumption. With imports of oil products amounting to about 10 percent of GDP at recent world prices, the Venezuela component is about 5 percent of GDP. With 40 percent of the latter value being concessional, and an implicit grant element of 50 percent, net resources from PetroCaribe could amount to about 1 percent of GDP per year.

The authorities indicated that they intend to spend the grant element on social projects, consistent with the PetroCaribe Agreement. At the time of discussions, the authorities were searching for appropriate projects, and the extent to which resources from PetroCaribe would generate new projects or support existing ones was not clear. The mission pointed to the need for careful planning in order to minimize the potential impact on the budget in case of an unexpected termination of the agreement

Despite the innovative and transparent vehicle that has been designed for extracting the grant element, some risks remain:

- *Credit risk.* To date, the zero-coupon instruments have been acquired from one local bank, implying a concentrated financial exposure. The authorities indicated that they intend to diversify these placements as the size of the funds increases, but pointed to the limited scope for this given thin regional financial markets.

- *Policy change risk.* Although the long-term liability to Venezuela is backed by financial assets in the first instance, the risk of a possible change in the government's policy intent remains, which could jeopardize debt sustainability over the long run.

- *Contingent liability risk.* If the agreement terminates unexpectedly, the authorities would need to provide resources for maintaining existing projects financed under the arrangement.

1/ The financed part is repaid in 23 equal payments after a two-year grace period during which the accrued interest is capitalized.

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## IMF Executive Board Concludes 2007 Article IV Consultation with Antigua and Barbuda

On February 4, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Antigua and Barbuda.[1]

### Background

Macroeconomic outcomes have strengthened significantly in recent years. Real GDP growth averaged 5 percent during 2003–05, and is estimated to have reached 12 percent in 2006. Economic activity was sustained by construction—mainly in hotels, but also public investment related to the Cricket World Cup (CWC). In 2007, growth is expected to moderate to about 6 percent, as construction activity slows. The external current account deficit widened in recent years due to surging world oil prices and construction-related imports. Money and credit growth have strengthened in recent years, reflecting strong economic activity. While recent growth outcomes have been favorable, Antigua and Barbuda remains vulnerable to exogenous shocks, given its dependence on imported oil, volatile tourism receipts, and exposure to natural disasters. High debt levels also leave it vulnerable to a tightening of regional and international financing conditions.

Despite the rebound in economic activity, fiscal imbalances have remained large, reflecting a number of one-off expenditures in 2006–07. Tax revenues have increased significantly, buoyed by the upturn in economic activity as well as the Antigua and Barbuda Sales Tax (ABST) introduced in January 2007. But spending has also surged, largely reflecting the effects of the CWC and one-time costs associated with the voluntary separation program for public employees. As a result, the primary deficit is expected to narrow to about 3 percent of GDP in

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

2007. Public debt, which fell from a peak of 143 percent of GDP in 2002 to 107 percent in 2006, has remained broadly stable during 2007. Notwithstanding the fiscal imbalances, the authorities have continued to ~~rollover~~ reissue debt on the regional government securities market at relatively low rates.

The CPI-based real effective exchange rate (REER) and the customer-weighted REER (which tracks REER movements relative to main tourism customers) have depreciated since 2002 with the weakening of the U.S. dollar. However, given the high level of public debt, substantial fiscal adjustment will be necessary to underpin the stability of the regional currency board arrangement.

There has been progress in implementing broad structural reforms. On fiscal issues, the authorities intend to enhance revenue performance, including the introduction of a more flexible mechanism for retail fuel pricing in 2008. They also intend to improve the investment climate, reduce skills mismatches, diversity exports, and deregulate telecommunications, with a view to enhancing the resilience of the economy to shocks.

**Executive Board Assessment**

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