Fiscal Responsibility Panel

2017

Annual Assessment

Bermuda

David Peretz (Chair)
Peter S. Heller
Jonathan Portes

December 2017

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List of Acronyms

AML: Anti Money Laundering

BELCO: Bermuda Electric Company

BHB: Bermuda Hospitals Board

BMA: Bermuda Monetary Authority

BTA: Bermuda Tourism Authority

CARTAC: IMF's Caribbean Technical Assistance Center

CFATF: Caribbean Financial Action Task Force

COLA: Cost of Living Adjustment

CPF: Contributory Pension Fund

CPI: Consumer Price Index

CTF: Counter-terrorism Financing

EU: European Union

GEHI: Government Employees Health Insurance Fund

GDP: Gross Domestic Product

GST: General Services Tax

HIP: Health Insurance Plan

IMF: International Monetary Fund

LNG: Liquefied Natural Gas

MMLPF: Ministers and Members of the Legislature Pension Fund

OECD: Organization for Economic Cooperation and Development

PSSF: Public Service Superannuation Fund

SAGE: Spending and Government Efficiency Commission

TRC: Tax Reform Commission

Executive Summary

1. This is the panel's third annual report and the first since this year's change of government. We are most grateful to the Ministers and officials who have given their time to discuss issues with us and to all those in the private sector who have given us their advice. As in our previous reports our conclusions and recommendations represent our own independent views.

2. In our previous reports we have highlighted Bermuda's vulnerability to external events, as a small open economy competing in a global marketplace. We have pointed out a number of specific risks and uncertainties that could adversely impact the economy. In some cases, the result could be a severe financial crisis; this would affect the wellbeing of all Bermudians. We have reassessed these risks in this report. But while some of the risks we identified last year have diminished, and some can and are being mitigated by determined government actions, others remain or have increased, and new ones will emerge. The high level of government debt and other contingent public financial liabilities leaves the island poorly equipped to deal with the potentially severe financial and economic impact if any one was to materialise. Moreover, given likely future expenditure needs arising from an ageing population, the government can ill afford to continue spending such a high proportion of its budget on debt service, which is currently the largest single category of government expenditure.

3. For all these reasons deficit and debt reduction should remain a high priority. We therefore welcome the new government's commitment to achieve budget balance by 2019 and to continue progress thereafter in reducing the volume of government debt accumulated in recent years so as to achieve the longer-term targets of reducing debt and debt service respectively to 80% and 10% of revenues.

4. Progress however has been mixed. In 2016/17 the fiscal deficit came out slightly lower than projected in the 2016 budget, with spending significantly below plans. The most recent fiscal plans for 2017/18 and beyond are those set out by the previous Minister in his 2017 budget. Relative to the plans set out in the 2016 budget these represent a significant degree of slippage, with a slowing of deficit reduction in 2017/18 and the target date for achieving budget balance pushed back from 2018/19 to 2019/20.

5. Looking forward it is our understanding that the new government's present intention is to permit a larger deficit in 2018/19 than foreseen in the 2017 budget – albeit a deficit less than the contribution to the sinking fund thereby avoiding any increase in net debt - while sticking to the target of budget balance the following year. This further slippage for 2018/19 coming on top of the slippage in the 2017 budget is unwelcome; such slippage can easily become a bad habit.

4. Last year we said that the government's aim of increasing taxes by the equivalent of 2 ½ to 3% of GDP to achieve the fiscal targets was appropriate but would not be easy and that implementation would be a challenge. This is even more true today.

5. On expenditure the challenge will be to contain the total within the current allocation, absorbing the costs of new initiatives and the recently agreed increase in wages and salaries through

increased efficiency. We welcome the government's intention to pursue increased efficiency with more determination than hitherto.

6. On tax the situation is more complex and the task more difficult. The former government introduced a reform of the payroll tax giving it a degree of progressivity, which we welcome, and new taxes on banking and insurance. The intention was to meet the revenue targets for 2018/2019 largely through a second stage of the payroll tax reform and the introduction of a new General Services Tax (GST). We understand that for next fiscal year the new government may proceed with part of the planned further payroll tax reform and the introduction of new taxes on some professional services but intends to leave a decision on whether or not to introduce a full GST until it has the report of the new Tax Reform Commission which will not be before the summer of 2018. This is likely to leave a revenue gap to be filled in 2018/19 and we make a number of suggestions.

7. We are disappointed that, despite our clear recommendation last year that the Office of the Tax Commissioner should be provided with additional resources, a number of posts remain unfilled because of a failure to streamline the necessary government recruitment approval processes. This needs to be addressed as a matter of urgency. Additional resources for tax collection and enforcement should pay for themselves many times over in additional revenue.

8. Looking further forward, with the growing needs of an ageing population we believe that over the longer term the revenue share will have to rise from its current level of around 17% GDP to a level nearer the 22-23% share seen in comparable small island economies; this will be necessary both to ensure a stable and robust fiscal position and to accommodate future expenditure pressures. The work of the Tax Reform Commission is thus critically important. We make a number of suggestions.

   - The current tax structure is excessively weighted towards the taxation of labour and goods and has the perverse effect of taxing companies that create employment while leaving those that do not largely tax free. Payroll tax will become an increasingly problematic source of income as Bermuda's comparative advantage to international companies as a place to do business is eroded through reductions in rates of corporation tax elsewhere. It will be essential to look for sources of revenue that spread the burden more evenly across the economy.

   - We continue to believe that a broader GST is needed as a way of spreading the tax burden more widely and raising revenue from the sector that is likely to be the fastest growing sector of the economy in future.

   - The government is right to be concerned about the degree of inequity in the distribution of income and wealth on the island and like governments elsewhere should pursue fiscal measures that address the issue. This should involve the taxation of dividend income where dividends are being taken as a form of salary payment, some more general taxation of significant incomes from capital, as well as the introduction of greater progressivity in the taxation of labour and possibly also in public pension fund and social insurance contributions.

- The Tax Reform Commission would greatly benefit from knowledgeable and independent external advice, probably by building on the government's on-going cooperation with CARTAC. And it is clear that as we recommended last year, the capacity of the Office of the Tax Commissioner will need to be significantly increased, with a further increase in resources.

9. The government is also right to be looking for ways to bring faster economic growth to the island. We welcome initiatives to improve training and to diversify the island's economy by attracting new industries as well as building on existing areas of business. Faster growth will ease the fiscal situation as well as improving the wellbeing of all Bermudians. As we have stressed in our previous reports, given demographic trends, it will be critical to success in these efforts to adopt an immigration policy and welcoming attitude that encourages qualified and skilled people of working age (including returning Bermudians) to come to the island, whether as employees or to establish new businesses, and to stay. This will also help improve the sustainability of the island's pension and health insurance arrangements.

10. We also make recommendations about two policy areas that will be hugely important over the medium and longer term.

- The island's costly healthcare system risks overwhelming the budget and the whole economy as the population becomes increasingly elderly and frailer, with more and more requiring long-term care. It will be important to pursue with determination measures now under consideration to control and reduce costs and to better target government subsidies to those most in need.

- Both the public-sector pension schemes and the Contributory Pension Fund remain substantially underfunded. It will be important to address this over time with a range of measures that should certainly include, as in other countries, a rise in the retirement age – a measure that also has the merit of increasing the working age population.

11. The new government thus faces a challenging agenda. We have been asked to continue our work and make a further assessment next year, and look forward to assessing progress then.

A. **Introduction**

1. The role of the Panel as set out in our letters of appointment is "to provide Bermuda's Parliament, Minister of Finance and Financial Policy Council with an annual published assessment of the territory's fiscal strategy, focusing on progress in meeting the territory's medium-term objectives for public spending, taxation, borrowing and debt reduction." In our initial reports we were asked to "review progress towards the Bermuda Government achieving a balanced budget by 2018/19…[and] prospects for further progress towards meeting the aims of reducing debt and debt service to less than 80% and 10% of revenues, and for implementing the rule that net borrowing can only be considered to finance capital spending." In making our assessment we are asked to "review the impact of the most recent Bermuda Government annual budget; the credibility of macro and fiscal assumptions underlying Government projections; and the risks that could affect progress in meeting the territory's fiscal goals…[offering]…advice where needed on ways to refine these goals, and on adjustments to fiscal strategy and tax and spending policies needed to achieve them."

2. This is our third annual report and our first report after the recent election and change of Government. We have had helpful discussions with new Ministers and their officials, who have given us a good understanding of policies of the new government relevant to our mandate. We would also like to thank many others on the island who have offered us information and advice either in face-to-face meetings or otherwise (a complete list is in Annex A). However, as in our previous reports, all the judgements and recommendations in this report are our own independent views.

3. While the Panel's initial appointments were for a three-year period only, the new government has now asked the Panel to continue its work in the future. We therefore look forward to making a further assessment of progress in a year's time.

4. In our report last year we listed key risks and uncertainties facing Bermuda's economy and re-emphasised our view that deficit and debt reduction must remain a high priority. In that context we welcomed some of the previous government's plans for tax increases, while warning that implementation would be a challenge and that further short and longer term actions would be needed in future on both revenues and expenditures. Since then some of the risks may have diminished while others have materialised. In addition, the fiscal situation has not evolved as anticipated. In particular, some tax measures were modified or delayed, and as a result, in its 2017 budget, the previous government allowed the target year for achieving budget balance to slip from 2018/19 to 2019/20. This slippage is unfortunate and given the priority that should be given to deficit and debt reduction we hope it will not be repeated.

5. Our judgement, as set out in our previous reports, about the need for deficit and debt reduction remains unchanged. Charts 1a and 1b show that while the growth of government debt has slowed in recent years the quantity of debt remains extremely high, both in absolute terms and in relation to government revenues. Net government debt is now approaching 2 1/2 billion dollars.

Chart 1a: Bermuda net government debt, $m

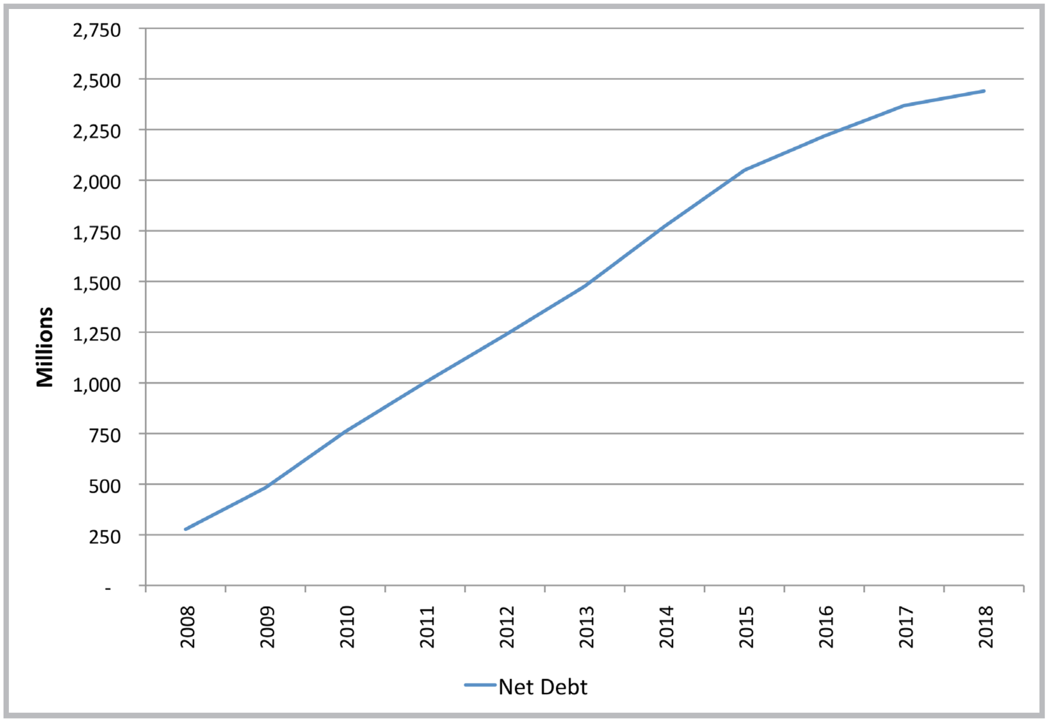
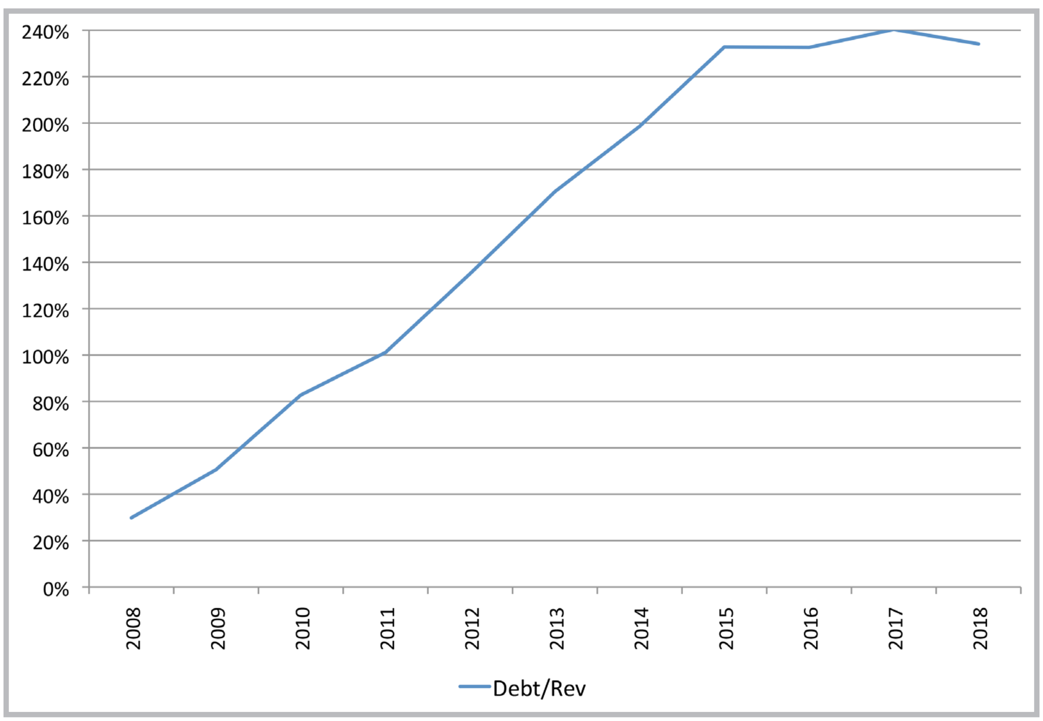


Chart 1b: Ratio of government debt to revenue, %



6. Debt service now accounts for 17% of government spending and is the single largest item of expenditure. In addition there are about $540m of outstanding government guarantees of debts by private and public sector bodies. And public pension and government health insurance schemes have sizeable unfunded liabilities (see Table 1 below) representing a further potential future claim on government financial resources. We therefore welcome the new government's commitment to achieve budget balance by 2019 and to continue progress thereafter in reducing the volume of government debt accumulated in recent years so as to achieve the longer-term targets of reducing debt and debt service respectively to 80% and 10% of revenues.

Table 1: Approximate Scale of the Government's Debts, Unfunded Liabilities and Outstanding Guarantees

	(in $ millions)
<u>Explicit Debt</u>	
Net debt of the Central Government (current)	**2428**
Outstanding Government Guarantees (current)	**540**
Net Unfunded Pension Liabilities for Government Employees (1)	**937**
Accrued Benefit Obligation for the Government Employees Health Insurance (GEHI) Fund (at end 2017)	**464**
<u>Implicit Debt</u>	
Net unfunded liabilities for the Contributory Pension Fund (CPF) (2014) (2) (3)	**500-4000**

<u>Notes:</u>
(1) Estimate for the Public Sector Superannuation Fund (PSSF) (2017) and the Ministers and Members of the Legislature Pension Fund (MMLPF) (2017)
(2) Not a legal obligation of the Government
(3) Variance is a function of interest rate assumption; latest actuarial estimates for 2014

7. The new government has different priorities from the previous administration and was elected on a programme with several elements relevant to our mandate. In section B we examine these and offer some comments of our own. Section C looks again at external developments and risks facing Bermuda's economy. Section D analyses the island's economic and fiscal prospects. Sections E and F look in more detail at a number of tax and expenditure issues and options and make some suggestions. Section G explores some important longer-term issues and section H summarises our conclusions and recommendations.

B. New Government Policies

8. The programme on which the new Government was elected includes a number of elements that could be relevant to prospects for fiscal stability. We have also taken account of announcements made since the election and have been able to clarify some points further in our discussions.

   - Like its predecessor, the new government is committed to the targets of achieving budget balance by 2019 and thereafter working to reduce net debt so as to achieve target ratios for debt and debt service to Government revenues of less than 80% and 10% respectively.

   - A "Tax Reform Commission" (TRC) has been announced with a broad membership, to review Bermuda's system of revenue collection and taxation and make recommendations for reform designed to make the system fairer, enhance competitiveness and increase jobs. Initially the Commission, which is likely to start its work in January, has a six-month deadline to produce its recommendations. As we discuss below there is an urgent need to raise more revenue over the next two years as well as a need for further revenue increases in the longer term. So the Commission's work is timely and important.

   - The "Bermuda First" Advisory Group has been established to develop a long-term economic and social vision for the island. And there are proposals designed to stimulate growth through direct interventions, including the creation of an Economic Diversification Unit.

   - The government intends to take forward the work of the bipartisan committee on immigration reform to ensure that the rights of Bermudians are advanced and protected while recognising the need to grow the economy with fair and balanced work permits and residential policies. The committee reported at the end of October 2017. The Home Affairs Department is now conducting a further review of policy.

   - On public expenditure, Parliamentary Oversight Committees are being established to improve governance, reduce waste and increase efficiency. There are also proposals to improve government efficiency through better use of technology, introducing performance-based-pay for public servants, and reviewing the SAGE Commission's proposals for consolidating government departments and ministries.

   - A new Bermuda Infrastructure Fund has been established that is intended to channel private sector investment into Bermuda infrastructure assets. The Government has agreed to underwrite the management fee. Possible projects range from energy and sewage to commercial and residential property. Public sector investment spending in Bermuda is low and the objective of stimulating private investment is sensible. However, with some of these projects, the government would need to guarantee a future income stream. In such cases, the key to securing value for money will be to genuinely transfer project risk.

   - A joint Parliamentary Select Committee has been established to make recommendations on establishing a legal minimum "living wage" for Bermuda. The fiscal implications of this proposal are unclear although, assuming it is set at a level that has no significant adverse impact on employment, it should not lead to any significant increase in the public sector wage bill and could lead to a modest increase in payroll tax receipts.

- Pensions paid under the CPF are now being uprated annually in line with the cost of living. To avoid an increase in underfunding this will need to be paid for by increased pension contributions possibly combined with an increase in the retirement age, as discussed further below.

- There are a number of other proposed changes affecting seniors, including expanding the homecare benefit available under the HIP, increasing the prescription drug benefit for seniors on FutureCare, and eliminating government fees for seniors in need. Each of these will add to pressures on public spending.

- And there are proposals to reduce healthcare costs and promote healthy living, including through the implementation of a new sugar tax.

9. This is an ambitious programme and, as we argue below, rapid implementation will not be easy given the territory's very limited administrative capacity. Although we note the intention of the government to contain costs within the total current expenditure allocation, including the cost of the recently agreed 2.5% increase in wages and salaries, there is also a risk that while in the long term some of the policies should support faster growth, in the more immediate future their overall impact could lead to increased rather than reduced fiscal pressures,

C. External developments, uncertainties and risks

10. Global growth has picked up. The US economy has continued to expand. Since the US is Bermuda's largest trading partner, and the source of the overwhelming majority of tourists, its economy's performance to date is good news. Moreover, after years of relative stagnation, the Eurozone is experiencing reasonably strong growth, and there are positive signs in Japan. Indeed, IMF Managing Director Christine Lagarde recently stated that the world economy was healthier than at any point since the financial crisis. Among major developed economies, prospects have weakened only in the UK, as a result of the fall in the exchange rate and increase in uncertainly after the Brexit referendum.

11. Financial markets remain extremely buoyant, with valuations at very high levels and volatility low. So far, at least, fears that moves, led by the Federal Reserve, towards "normalisation" of monetary policy would result in market disturbances have not materialised.

12. In addition to the potential impact of general global economic developments in our previous reports we have stressed a number of more specific threats to Bermuda's economy. Of those we mentioned in our 2016 report we would this year highlight in particular:

- *Risks from global initiatives in financial regulation.* The upcoming Caribbean Financial Action Task Force (CFATF) assessment of Bermuda's Anti-Money Laundering (AML) and

Counter-Terrorism Financing (CTF) measures remains critically important: a less than positive report would carry a high risk of major damage to Bermuda's financial services businesses. Many might choose to leave. This remains a serious possibility. Despite all the work that has been and is being done there remain a few critical tasks to complete by summer 2018, some requiring additional resources, if Bermuda is to secure a positive outcome. And even a positive outcome is likely to involve a requirement for work to further improve the system.

- *Potential EU action to blacklist Bermuda as a "non-co-operative" tax jurisdiction under the EU Code of Conduct initiative*. It is important to recognize the strong political motivation of those in the EU who object to Bermuda's facilitation of corporate vehicles with no substantial business on the island and the absence of corporation tax, and who wish to include Bermuda on any blacklist of "non-cooperative" jurisdictions. Reactions to the Paradise Papers leak illustrate how strong the risk is. While Bermuda has avoided being placed on the EU's initial blacklist and is recognized as a highly transparent jurisdiction, along with other jurisdictions it has also been given a deadline to address concerns that companies that benefit from Bermuda's corporate tax regime should have a real and substantial economic presence on the island. And we remain of the view that at some point in the future avoiding adverse action may well also entail considering modifications to the current corporate tax structure. It will also be important to maintain Solvency II equivalence for insurance regulation; the European Commission will be reviewing Solvency II requirements at the end of 2018. Bermuda needs to continue to develop its strategy to engage with the EU post-Brexit.

- *US tax reform.* Last year we were concerned by some proposals in the Republican Party agenda for corporate tax reform that could have a major impact on Bermuda's insurance and reinsurance industry. At the time of writing it seems possible that the tax bill that eventually emerges from the US Congressional reconciliation process will contain measures that would tax payments of insurance premiums made from the US to offshore companies, which would adversely affect Bermuda's insurance businesses. Even if it does not, there would remain the more general impact of the planned significant reduction of US corporate tax rates on Bermuda's comparative advantage as a place to do business. Bermuda will need to continue to seek to avoid actions that reduce its attractiveness to international businesses and to keep a close eye on developments in Washington.

- *The general rise in populism and economic nationalism in advanced economies*. The risk remains that this might lead to measures that would adversely affect Bermuda, which benefits hugely from globalisation in general and international capital mobility in particular. Moreover, many political developments over the last two years, from Brexit to the US presidential election result, reflect at least in part the sustained stagnation in real wages and living standards that followed the financial crisis. It is vital that politicians, in Bermuda as elsewhere, address the root causes of poverty, inequality and wage stagnation, while at the same time avoiding the temptations of protectionism.

- *Impact of global warming and climate change.* With global warming, extreme weather events are becoming more frequent. Bermuda escaped the impact of the hurricanes this year that did so much damage in the southern US and in the Caribbean. The island may not be so fortunate in the future. There are a number of implications for Bermuda, some negative and some positive:

- Even when such events occur elsewhere they impact on Bermuda's insurance and reinsurance businesses, in the short term leading to significant pay-outs, but in the longer term possibly leading to higher insurance rates and increased business.

- To the extent that the severity of extreme weather events has been aggravated – as seems likely – by climate change, reinsurers will need to consider how to reflect this in their business model and pricing policy going forward.

- The possible increase in the severity and frequency of tropical storms and hurricanes in the Caribbean is potentially an opportunity for the Bermudian tourist industry, since Bermuda has so far been unscathed this year, while a considerable amount of capacity in the Caribbean has been destroyed.

- Nevertheless, the near-destruction of some Caribbean islands is a warning. Bermuda appears generally well prepared for extreme weather, and has coped well in the past; this year's events emphasise the importance of continued investment in planning and preparation to ensure resilience.

- *Effects of an ageing population, declining workforce, underfunded public sector pension funds and escalating health care costs.* This remains a certainty, not just a risk, which will result in serious longer-term pressures on public spending, challenges to growth, and make it more difficult to deal with a large debt overhang. Concern about this is a further factor that could ultimately trigger a downgrade by rating agencies, as has happened elsewhere.

13. As a small open island economy, Bermuda is of course exposed to many other potential risks and uncertainties. For example if – as many now predict – there were to be a sharp downward correction in world stock markets this could affect Bermuda's tourism business, and also, probably, add significantly to the underfunding of the island's pension schemes. While some of the risks listed above may have diminished, at least temporarily, others remain the same or have increased.

14. The key point is that any shock that has a significant negative impact on Bermuda's economy could trigger a fiscal and financial crisis. With its current level of debt, reliance on external finance, no possibility of an independent monetary policy given the currency link to the US dollar, and no effective lender of last resort arrangement for domestic banks, the island is not well equipped to handle such an event. The impact on the wellbeing of all Bermudians would be severe. Improving resilience by pursuing fiscal balance and debt reduction therefore should remain an overriding priority.

D. Bermuda's economy and fiscal and debt prospects.

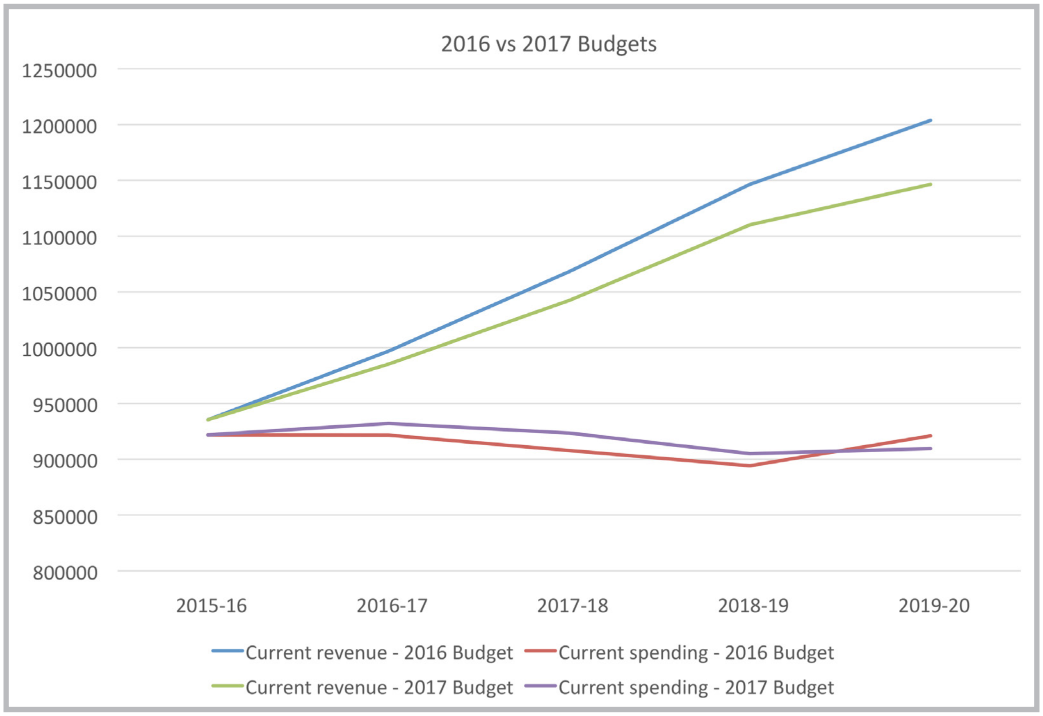
15. GDP was flat in 2016, although this may reflect oddities with the measurement of the GDP deflator (GDP grew by 3.4 per cent at market prices). It also fell slightly year on year in the first quarter of 2017, but this was entirely driven by a reduction in the current account surplus; domestic consumption and investment increased. More recent retail sales data also suggest modest underlying growth. Encouragingly, while not spectacular, this growth appears to be broadly based, and not solely the result of the short-term boost to capital expenditure and tourism resulting from the America's Cup, although this has clearly had some impact. Consumer confidence and consumer spending appear to have revived and the labour market has improved. Tourism has been a particular bright spot, with the strategy of the Bermuda Tourism Authority (BTA) beginning to pay off. Overall, absent a significant external shock, growth prospects for the short to medium term appear reasonably positive. Over the longer term, however, demographic pressures will dampen Bermuda's sustainable rate of growth.

16. This brightening picture ought to make the on-going task of restoring Bermuda's public finances to sustainability easier, both economically and politically. There was some progress in 2016-17: the budget outturn was somewhat better than that set out in the 2016 Budget, with spending significantly below plans, and revenues broadly on track. With some savings on debt interest, as the government continued to refinance at lower than expected interest rates, the deficit was about $17m below target. Overall, budget planning and implementation has in the past been reasonably robust.

17. This meant that the current primary balance (that is, current revenues minus current spending, excluding interest payments and capital spending) was again positive in 2016/17. However, the deficit remains high – indeed the overall deficit was actually more than $20m higher than in 2015-16, as a result of spending in the run-up to the America's Cup, although there was some underlying structural improvement – and both the debt to GDP and the debt to revenue ratio have continued to rise.

18. The most recent fiscal plans for 2017/18 and beyond are those set out by the previous government in the 2017 Budget. These are obviously subject to change to reflect the policies and priorities of the new administration, as explained below. However, they provide a useful comparison to our last report from December 2016. Relative to that report, which in turn was based largely on plans published in the 2016 Budget, there is further significant slippage in subsequent years. In particular, there was a significant slowing of deficit reduction in 2017/18 and the target of budget balance by 2018/19 was pushed back a year, to 2019/20, driven largely by a revenue shortfall of about $35m. Indeed, the revenue target set in the 2016 budget for 2018/19 – $1.146 billion – was simply pushed backwards by one year in the 2017 budget.

Chart 2: Comparison of 2016 and 2017 Budgets



19. Deficit reduction in 2017/18 is substantial, but is flattered by the inclusion of a one-off reduction of $25m in the grant to the Bermuda Hospital Board (BHB). So far the outturn for 2017-18 appears broadly consistent with these plans, with the latest available data, for the first half of the year, showing spending on track (although current spending was slightly above half of that allocated for the full year, matched by a slight shortfall in capital expenditure). Tax revenues are running well ahead of the previous year, although this is likely to reflect in part higher expenditure by visitors during the America's Cup, which will largely be a one-off. It will be vital that the new government maintains firm control over spending and sticks to the overall budget envelope for the current year, balancing any in-year increases with offsetting reductions.

20. All this reflects a continuation of trends identified in our previous report. That is, the scope for further incremental expenditure reductions has largely been exhausted, and indeed there are significant pressures for increases in some areas, particularly relating to social spending. That means that an increasing proportion of the burden of deficit reduction must fall on tax increases; but lack of administrative capacity means that the implementation of major new taxes, such as the proposed GST or structural reforms to existing taxes, is slower than planned.

21. Looking forward, our understanding is that the new government's current intention is to target a deficit in 2018-19 that is no greater than the Sinking Fund contribution, ensuring that net debt falls over the course of the year. This implies a deficit, on the government's preferred definition (that is, after Sinking Fund payments) of about $65m, more than double the $26m target set out in the 2017 Budget, with expenditure roughly flat in cash terms (instead of falling by about

$18m) and revenues also falling short.[1] While this would still represent a significant reduction in the deficit from the current year, this further slippage, coming on top of that seen under the previous government's budget, is unwelcome.

22. We understand that the government intends to stick to the aim of budget balance by 2019/20. We emphasise again the importance of avoiding slippage in the trajectory to achieve that end. As the table below shows, this can easily become a bad habit; the small surplus originally projected for 2018-19, in the 2016 budget, has already become a deficit of more than $60m Even delivering this, let alone the target of balance in 2019-20, is likely to require further timely action on tax measures, as set out below.

Table 2: Evolution of Forecasts for the Fiscal Deficit in Successive Budgets ($1000s)

		FISCAL YEAR					
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
	Feb-14	-267,267	-196,660	-148,132			
	Feb-15		-220,049	-151,022	-127,096		
BUDGET PUBLISHED	Feb-16			-199,394	-97,737	4,643	
	Feb-17				-134,678	-26,379	5,732
(provisional)	Feb-18					-65,460	0
	Outturn/projection	-265,331	-160,638	-182,050	-134,678		

23. In our last report, we said that the broad macroeconomic and fiscal strategy – in particular, the objective of implementing a structural increase in tax revenues of 2 ½ to 3 per cent of GDP over the next 2 years, through a combination of increases in existing taxes and the introduction of the GST, while continuing to control spending – was appropriate. But we also noted that the key challenge was implementation, and that any slippage, either in spending control or in the introduction of revenue-enhancing tax changes, would be undesirable. These risks have now materialised, and it will be important for the new government to set out an ambitious but realistic strategy for continued progress.

24. Bermuda does not face a fiscal emergency – with debt/GDP and debt/revenue ratios now having been stabilised, there is no immediate prospect of a debt spiral. But it does face serious risks, and its vulnerability to those risks will be aggravated if the progress made in recent years is not maintained. This is illustrated in the chart below, which shows the debt/revenue ratio under a number of scenarios.

- The "base case" is consistent with the policy of the new government, with no increase in net debt in 2018-19 and budget balance thereafter. Revenue and expenditure (excluding debt interest) are assumed to grow at 4% (roughly the expected trend growth of nominal GDP,

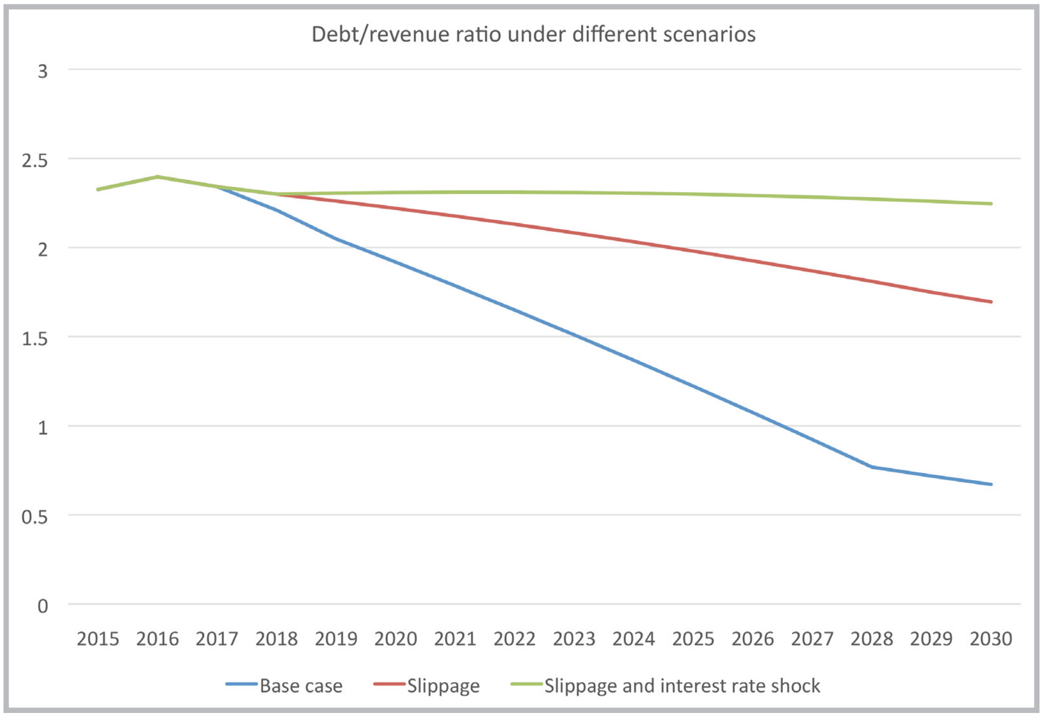
1 We understand that the savings in 2017 from the cut in the subsidy to the BHB will not be repeated but there will be offsetting savings from non-repetition of the funds expended in 2017 for the America's Cup.

or perhaps slightly faster) after the end of the budgetary period in 2019/20. This shows the debt ratio falling at an accelerating pace, and hitting the government's target by 2028.

- The "slippage" scenario shows the impact of a halt to fiscal consolidation after the current year, with both revenues and expenditures growing by 4% in nominal terms from 2018/19 on. The debt ratio falls, but slowly, and is still at 170% in 2030.

- Finally, the interest rate shock scenario shows the impact of slippage combined with a significant, but plausible, increase in the effective interest rate payable on Bermuda government debt, from an assumed 5% to 7%, beginning in 2019-20.[2] Under this scenario, the debt ratio remains very high for the foreseeable future, and is still at 225% in 2030.

Chart 3: Debt/revenue under different scenarios (%)



25. The negative scenarios here are not alarmist – they are far from being out of line with Bermuda's historical experience. They thus represent the continued vulnerability of Bermuda's public finances to negative shocks, internal and external, and emphasise the need for continued progress to ensure that Bermuda is in a position to withstand such shocks.

2 This scenario is illustrative; the precise impact of an interest rate shock will depend on the maturity profile of Bermudian debt and market conditions at the time further external finance is required. Bermuda has managed its debt well and faces no immediate financing constraints. Nevertheless, a 7% rate would not be abnormal by historical standards, and this is certainly not the worst possible scenario.

E. Past and prospective tax reform

26. In our 2016 report we noted the government's planned reform of the payroll tax would need to produce a large part of the $150m of extra revenues needed to meet the target of budget balance in 2018/19. The proposed GST was assumed to produce $50m in 2018/19, on the basis of a target introduction date of April 2018. We warned that almost certainly other sources of revenue would need to be considered if the 2018/19 deficit target was to be met, and we suggested some options. We also noted that the tax reform agenda would be challenging and would require extra resources at the Office of the Tax Commissioner (and tax-related functions at the Finance Ministry).

27. In the event the reform of payroll tax announced in the 2017 budget is projected to produce around $50m extra in revenue in 2017/18, with additional revenues in 2018-19. This was supplemented by other measures to improve the fiscal balance:

- Introduction of a financial services tax on banking, money service businesses and insurance, projected to yield around $11m a year.

- Increases in customs duties and excise taxes to yield an additional $14m a year.

- A one-off reduction in payments to the BHB, using accumulated savings at the Board, of $25m.

28. The 2017 budget introduced some notable and important tax policy changes. The reform of the payroll tax system providing for greater progressivity; introduction of a tax on some services; a customs reform involving a move to a more unified tariff rate structure; increased excises on alcohol, tobacco and petroleum products; and a Financial Services Tax. Each of these reforms was consistent with the policy recommendations in our Panel Report of 2016. Soon after the Budget Speech, the Ministry of Finance halted the announced customs duty reforms, pending reconsideration. However, this was compensated for by increases in other duty rates.

29. We understand that the new administration intends to continue with at least part of the planned payroll tax changes now being implemented over a two-year period, with the changes in the rates on employees beginning in July 2017 and continued in 2018/19 with greater progressivity in the rate structure. However, there is uncertainty about other policy changes. The GST will not be implemented in 2018 as proposed by the previous government, but we understand that, possibly as an interim measure, a Professional Services tax is to be implemented in 2018/19, limited initially to services provided in the legal and accounting professions. This will inevitably give a lower revenue yield than a fully-fledged GST. Further extension of the GST will be considered by the TRC (see below).

30. This approach is likely to leave the Government with a short-term revenue gap over the next two years that will need to be filled by other measures. Specific options include:

- A very significant increase in registration fees charged to companies that do not have a genuine economic presence on the island, perhaps graduated according to their turnover. This would both raise revenue, and represent a clear "down payment" on the government's commitment to address this issue in the context of the EU Code of Conduct Initiative (see section C).

- The government's general review of fees and charges.

- Addressing the large amount of uncollected tax; as noted below, this will require some increase in the resources of the Office of the Tax Commissioner.

- The new Government's proposal of a tax on sugar products, with revenue earmarked for health education and early preventive health interventions, which is also sensible on public health grounds.

31. Moreover, looking beyond the next two years, we believe that Bermuda's current tax regime will prove inadequate in terms of the revenue share in GDP that it will mobilize. Given the looming costs of an ageing population, the need for further debt reduction, and the need for infrastructure and human capital investments to promote growth, we believe that the revenue share over the longer term will probably need to rise to match the share in comparable small island economies, viz., perhaps in the range of 22-23 percent of GDP – that is around 4-5% of GDP above the level currently projected for 2019.

32. Income and wealth inequality is high in Bermuda. This is not unusual in financial centres – it is also true of London and New York – but the particular structure of the Bermudian economy and society, with much of the employment in the international business sector being comprised of very well-paid expatriates, means that its political salience is even higher. Addressing these disparities – a key focus of the newly elected government – will require action across a range of fronts, from economic development to education to social assistance. However, tax policy needs to be a particular priority. The current tax structure is excessively weighted towards the taxation of labour and of goods. It also has the perverse effect of taxing companies that bring employment to the island, through the payroll tax, while leaving those that do not bring employment largely tax free. Moreover, dividend income from partnerships – much of which is effectively labour income – is also untaxed.

33. Over the medium-term, a broadening of the tax base, with an increased focus on equity and reducing perverse incentives is thus essential. We continue to believe that a broader General Services Tax is needed on equity, efficiency and revenue mobilization grounds. But tax reform cannot end there. Both equity and efficiency are likely to require the following:

- An increase in the progressivity of existing taxes on labour, alongside broadening their base, by ending the current privileged position of those who take dividend income as a substitute for income from employment.

- Taxation of the capital income of Bermuda's citizens, including dividends, interest, rent and capital gains. This could be on a schedular basis, perhaps introduced piecemeal over time and with an exemption for an initial tranche of capital income. It is worth noting that other similar jurisdictions, such as Jersey and Guernsey, tax income from capital in the context of normal income tax regimes.

- While the Government has made commitments to foreign corporations to not levy a corporate profits tax until 2035, as noted above, there may be other options to raise revenue from the corporate sector, for example by an increase in registration fees for exempt companies, perhaps with the level of fees graduated according to corporate turnover.

- Greater progressivity could also be introduced in the amount of contributions to the CPF (by moving from fixed rate contributions to a percentage of earnings), as well as in any future options for financing health care and/or long-term care.

34. Such reforms will neither come easily nor soon, whether due to the inherent political economy challenges or in terms of administrative requirements for implementation. They should be seen as policy efforts that can come to fruition possibly in 2019/20 or 2020/21. But now is the time when consideration of viable policy alternatives should begin. The relatively benign global economic environment provides a helpful background for considering tax increases. The work of the recently constituted TRC is thus critical: we hope it will see its task as promoting reforms that will at the same time raise revenue and increase fairness, competitiveness, growth and employment. We believe that the Commission could benefit greatly from knowledgeable outside expert advice and note that this could easily be had by building on the government's ongoing cooperation with CARTAC, which has great experience on the practicalities of reforming taxes in similar small jurisdictions.

35. Last but not least, we have emphasized in earlier reports the need for a strengthened tax administration. We were extremely disappointed that while provision was made for a number of posts, these largely remain unfilled because of delays in the government recruitment approval process. In our view, this is unacceptable. Failing to staff the Office of the Tax Commissioner properly is a false economy in the worst possible sense, as extra resources are likely to pay for themselves many times over in extra revenue. This needs to be addressed as a matter of urgency.

36. More broadly, going forward, even when fully staffed the current resources and capacity of the Office are unlikely to be adequate to implement the reforms currently in progress, let alone any more radical changes recommended by the TRC. In addition, the compliance and audit functions, which currently operate in a reactive fashion, also need to be strengthened so that they can be more risk-based and proactive. This too would likely yield increases in government revenue. Finally, the government should consider whether the courts are currently doing enough to ensure that those who evade taxes are required to pay taxes due as well as any penalties, and whether any further legislative action is needed.

37. Our report last year also noted the current preferential and costly tax concessions to the Bermuda Energy company (BELCO). There are several challenging issues associated with the role of BELCO in Bermuda, including its monopoly role, its need for new investments in relation to an ageing plant, the relative balance to be struck between coal-fired and LNG

electricity generation, and the future role of renewables (notably solar) in supplying electricity to Bermuda in the future. We also recognize the burden of energy costs particularly for low-income groups, both wage earners and retired elderly, and the putative role of the tax concession in limiting this burden. But as is common with government price subsidies, middle and upper income groups realize much of the benefits. Removal of the tax concessions and an approach to targeting energy assistance would both save budgetary resources and promote distributional equity among Bermuda's citizens. As the new Government formulates its policy on BELCO, the revenue cost of the tax concession needs to be considered.

F. Expenditure policy issues

38. **Expenditure rationalization:** Last year's Panel Report emphasized the continuing importance of efforts to prioritize more effectively government budgetary allocations to "address inefficiencies and to demonstrate the Government's commitment to improve efficiency and reduce waste." The then Opposition in its reply to the 2017 Budget Speech echoed this view. It noted "making cuts without focusing on efficiencies can make our budget problems worse." We stressed this is not only a matter of realizing budgetary savings but as a means both to reduce constraints on new business investment and to allay concerns that increases in the tax burden are principally in support of inefficient expenditure patterns. We also emphasized that an increase in spending in some areas (such as in tax administration or tourism marketing) might yield greater revenue or higher economic growth. In some areas, privatization or creation of "quangos" might yield increased efficiency. We are not advocating another SAGE Commission: its report yielded sufficient proposals for reform that still could be drawn on.

39. Nevertheless, we were struck by the limited policy changes signaled in the 2017 budget (for the 2017/18 fiscal year). Essentially, increases were limited to a few priority areas—public education, national security, and the BTA. There is little evidence that any significant rationalization in the approach to public service delivery was envisaged or has eventuated in the last two years. We are encouraged that the new Government intends to reconsider its expenditure policy priorities in the 2018 budget, both with a focus on new growth-promoting policy initiatives and on realizing greater efficiency arising from expenditure audits.

40. **Spending on health care:** After debt service, the government's involvement in the health care sector is the largest area of spending in the budget. While Bermuda relies on a mixed public-private health insurance system, the salient feature affecting the budget is the substantial subsidy provided to the elderly, with a 70% subsidy for those in the 65-74 age bracket and an 80% subsidy for those aged 75 and over.[3] Unlike many developed jurisdictions, Bermuda's patient subsidy system does not involve income or resource-based means testing, thus leaving

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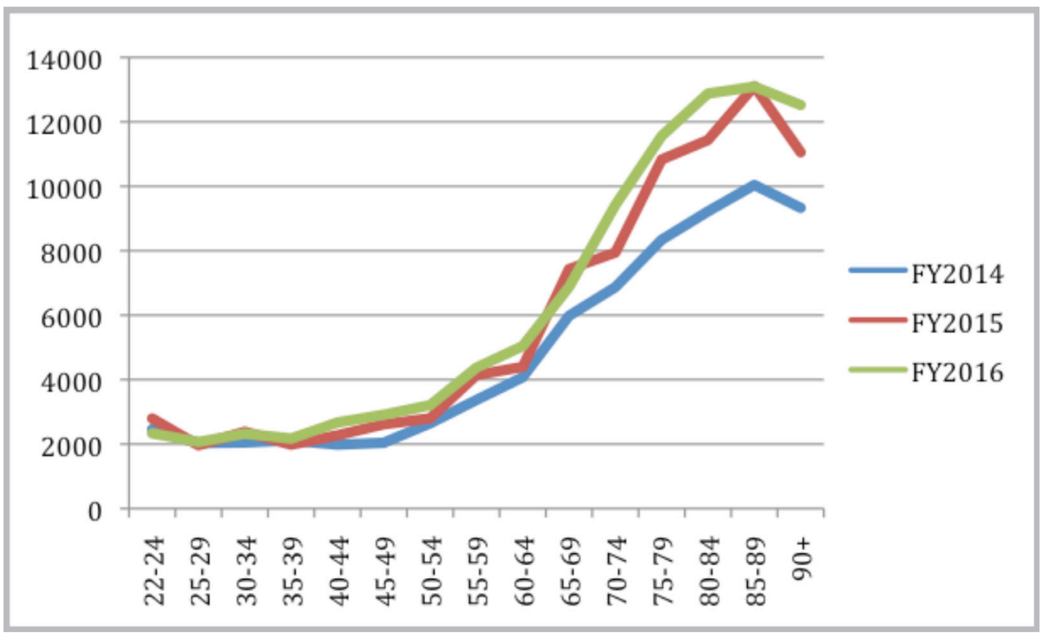
3 The other principal source of budgetary concern in the health care sector derives from the roughly $435 million in unfunded liabilities with respect to the Government's insurance coverage for its own retirees (through the GEHI). Here the Government did take action over the last couple of years to reduce the scale of the liabilities, by increasing contribution rates by both the Government and members, and reducing the Government's share of contributions for premiums in relation to the spouses of retired government employees.

it susceptible to significant cost increases due to general demographic changes. It is well recognized that Bermuda's health care costs, as a share of GDP and in per capita terms, are among the highest in the world, with per capita costs rising sharply and relatively continuously from age 50 onwards. These costs have progressively increased over time, as indicated in the most recent 2017 Bermuda Health Council (BHC) *Actuarial Review* (Chart 4). With the further anticipated ageing of Bermuda's population, the Government in 2016 launched its Bermuda Health Strategy, supported by a Bermuda Health Action Plan and Long-Term Care Action Plan that have led to a number of initiatives in the last two years. Some revisiting of the approach toward health subsidies for the elderly will be critical to any effort to contain future budgetary spending over the medium to longer term. In particular, some form of means testing should be considered to determine eligibility by the elderly for any subsidy for health care expenses. Such initiatives are not only vital to limiting budgetary pressures but also will be critical if the Government is to keep a lid on wage costs on the island that are already burdened by the cost of health insurance.

Chart 4: Total Annual Per Capita Claim Costs: FY 2014-2016 by age group (In Bermuda dollars)



41. The last fiscal year saw some progress in containing subsidies and costs. The actual Government Patient Subsidies were capped in 2017 by legislatively converting them from fee-for-service basis to a block grant. As noted earlier, the 2017 budget also included a one-time $25 million cut in the grant to the BHB. Cost control efforts included reducing reimbursement rates for dialysis sessions (from $1300 per session to $964, though these still are above international standards); diagnostic imaging; and long-stay beds (from $33,000 per month to $20,000). This resulted in $20 million worth of fee reductions. An important initiative undertaken in 2017 sought to improve competition by creating better parity in reimbursement between the island's care settings with respect to diagnostic imaging fees. In addition, the Government sought to reduce costs by improving the management of chronic conditions as a means of future cost avoidance. For example, the Enhanced Care Pilot and the Patient Centered Medical Home have so far

been successful in improving access to primary care for the under and uninsured participants with chronic conditions (and in the long term will reduce more complex care utilization). The Personal Care Benefit is enabling safe home care that avoids costly hospitalization. In addition, palliative care is now covered in the home setting. Much credit for these reforms can be given both to the work of the Ministry of Health and the BHC.

42. The private medical care sector in Bermuda is largely unregulated, raising concerns about both the cost and quality of the care provided and of pharmaceutical products. Further efforts are therefore needed to strengthen the regulation of private sector providers (including their use of health technology) as a means to reduce duplication that adversely impacts health care costs and exposes patients to unnecessary risk. A legislative initiative in this direction failed to be passed in 2017. Before deciding on future policy, it may be necessary to collect more robust data for analysis of consumer demand, determinants of use, and utilization trends. We believe that an appropriate regulatory infrastructure with enforcement resources remains a necessary element of an overall health care strategy for Bermuda.

43. Further initiatives are needed in terms of Bermuda's policy with regard to overseas medical expenditure. While it is recognized that a small island economy cannot afford many forms of medical care, the recent BHC review of expenditure on international treatment reveals that Bermuda is very much an outlier in terms of the share of its health expenditure that takes place outside of the country, particularly when compared to several other small island economies (e.g. Dominica, Barbados, and the Seychelles). This raises the question of whether there might be scope for more in-island treatment of certain categories of inpatient care or for working with insurers to partner with designated overseas hospital centers for the treatment of Bermuda residents

44. **Education initiatives:** We welcome the new Government's focus on promoting economic diversification as a central instrument for promoting future growth and hope that the Bermuda First Advisory Group tasked with formulating a policy strategy will be up and running soon enough to influence budget priorities in future budget years. Enhancing the skill set of Bermuda's students will be vital to ensuring the necessary adaptability required to respond to new potential job opportunities in an economy that will shift in its employment requirements, in part as a consequence of the impact of continuing artificial intelligence developments. This requires significant investments in the education sector to enhance the stock of available computer equipment in schools and to strengthen the technology-mix of the courses offered. This will require not only additional budgets for equipment but also for training and employment of teachers able to provide the requisite educational curriculum. An ageing population is also likely to create a demand for those skilled in the "caring" professions and promoting training and education in this sphere may also yield benefits in creating jobs and enhancing the potential of the caring sector to address long-term care deficits. There is also a need for more apprenticeship and in-work training programmes and more support to help job seekers find jobs.

45. **Regional diversification:** Looking to the medium term, some commentators have argued for promoting poles of urban growth outside Hamilton at the ends of the island, both as a

means of stimulating employment and investment to other parts of the island and as a means of containing the traffic congestion characterizing Hamilton. This argues for infrastructure investments that reduce startup costs for businesses and facilitate easy access to employment in these other areas including initiatives to reduce the heavy reliance on private automobiles on the island. This may prove a natural follow on from the infrastructure investments from the Dockyard to Morgan's point (associated with the America's Cup), the solar panels project (near the old airport), the East End (where the new airport project will be put), and St. George's (associated with new hotel construction).

46. **Social Assistance:** Since the election, a discussion on social assistance policies has identified some problems with the present approach, particularly concerning the disincentives that may be created for employment. With a negative marginal tax rate of 100%, it is not surprising that such problems may arise. But Bermuda also needs to face the challenges arising from its significant poverty rate (estimated by some at 23 percent) and the possibility of technology-driven losses of employment in the coming decade. The current legislative debate on a "living wage" is symptomatic of the political resonance of this issue that is driving a debate in many industrial countries over the role that could be played by a universal benefit grant in a world where many jobs may be lost due to artificial intelligence. Bermuda needs to take these issues seriously and not play "policy catch-up" as the socio-economic environment confronts structural shocks. In this regard, introduction of an unemployment insurance scheme, if well designed, could be a useful element of a future social insurance policy framework.

G. Longer Term Issues

47. **Demographics**. In our previous reports we emphasized that measures to bring down the level of debt and support Bermuda's growth are also important because of the budget pressures that will be faced by Bermuda as its population both becomes increasingly aged and smaller in the coming decades. The prospective shrinking of the population, and in particular of its labour force, will make it more difficult for Bermuda to achieve significant economic growth during this period.[4] It will also create challenges for mobilizing revenue to finance the provision of government services and for needed investments in infrastructure. Moreover, looking to the longer term, the budget will also be required to finance outstanding pension obligations to retired civil servants and to support existing government policies that subsidize medical care for the elderly as well as long-term care under FutureCare. Bermuda's already costly medical care system will be hard pressed to contain spending with demands for new medical care surgical and diagnostic procedures and pharmaceuticals. While other elements of Bermuda's social insurance system (viz., the CPF and social assistance) are not formally contingent liabilities to the budget, one could envisage that unfunded liabilities in these spheres might also create pressures for additional budgetary spending. Policy makers will also need to reckon with the politics of a health care system that leaves many lower income Bermudians underinsured and thus exposed to health and long-term care risks.

4 The adverse effects of these demographic forces on the potential labour force will be further exacerbated by the need for many families to take care of elderly relatives.

48. **Immigration:** A revisiting of Bermuda's immigration policy might provide some relief from these pressures, facilitating at least some net growth in the labour force, particularly if targeted to encouraging the return of overseas Bermudians with marketable skills and the provision of citizenship to the families of noncitizens that have been resident in Bermuda for a significant period and wish to remain. The recent recommendations of the Working Group on Immigration Reform are an important first step in this direction. The effort to broaden the consultation process on these reforms should allow a broader consensus to emerge and provide greater popular support than was the case in the abortive reform effort of 2016.

49. Bermuda's economy and society vitally depends on an international business sector involving many non-Bermudians. The Government needs to make it clear that it welcomes this contribution. We thus support policy initiatives that encourage immigration of skilled workers in support of new business initiatives. This needs to be complemented by equally strong support at the administrative level to ensure such initiatives are expeditiously implemented and to make the process of securing work permits more user friendly. Over the longer term, an immigration policy that supports both growth and economic and social integration is in the interest of all Bermudians, and it will be important for all stakeholders to approach what is inevitably a charged debate with this in mind. We hope that the policy review now under way in the Home Affairs Department will result in the needed changes to practices and policy.

50. **Long-Term care.** Last year's report also emphasized the challenges that can be anticipated, looking forward a few decades, in the long-term care sector. The Government's principal initiative, *FutureCare*, an optional supplementary health insurance program for the elderly, seeks to shift the focus of long-term care away from a hospital setting. But still more than half of the BHB's beds are now devoted to long-term care. While many Bermudians are insured through their employers, those who are self-employed or not so-covered, must pay the additional premium, leading some to opt out of insurance coverage if seen as unaffordable. Such gaps in coverage can burden the overall health care system, leading those in need of long-term care to seek coverage in the hospital system at much higher inpatient costs. We have also noted that FutureCare does not address the challenge that will arise as more seniors move into age brackets where there is a high probability of dementia. The new Government will need to develop a Long-Term Care Strategy to address the long-term care cost pressures that may emerge in the coming two decades (as a larger share of the population moves into their 80s). Efforts to strengthen primary and secondary prevention initiatives among the general population are also needed to reduce the future scale of demand for health care among the elderly.

51. **Pensions.** The Bermuda government's explicit pension challenge is an unfunded pension liability of approximately $937m to its employees within the framework of its PSSF and for former ministers and parliamentarians (under the MMLPF). While not liabilities to external bondholders, the need for servicing these pension obligations will burden future budgets no less urgently. Outstanding proposals from the previous Government's Pension Benefit Working Group highlighted the need for reforms to strengthen the PSSF's financial position, by increasing the retirement age for unreduced pensions and shifting to a final 5-year average salary as the basis for calculating the pension.

52. The Bermuda government also manages the CPF, the country's first tier pension system. Last year's Panel Report discussed the latest actuarial review of the CPF (for 2014), which both highlighted its long-term financial weakness (with its assets likely to be depleted by 2049) and recommended possible reforms to contribution rates and benefits that would enhance the financial sustainability of the system. That review indicated unfunded liabilities ranging from $500m to $4 billion, depending on the calculation of the value of future benefits. Our report also noted that the actuarial review might have understated the potential risks that could arise if the financial environment fails to deliver an adequate real rate of return on investments. The latter possibility is also a risk faced by Bermudians reliant on privately managed pension returns.

53. While the government is not legally obligated to cover any CPF shortfall (let alone shortfalls in private schemes), the CPF system plays too significant a role for the retirement income support of an important segment of the population (particularly in conjunction with other supports for the health care system) for the Government to allow it to fail. The need for action in adjusting the contribution and benefit formulae and the age of eligibility for receiving CPF benefits remains an urgent priority for action by the new Government. While we support the introduction of an annual COLA for CPF benefits by the new government, we suggest this should form part of a package designed on balance to increase the Fund's sustainability by increasing contribution rates and increasing the age of eligibility for receiving CPF benefits.

54. We emphasized last year that there is a need for a vital dialogue with all Bermudians on the challenges that will arise as the population ages and on the need for a revisiting of existing views on the work-retirement balance during the elderly years. Like many other developed countries, over the years Bermuda constructed a health and social welfare system that is now proving financially vulnerable to the effects of changing social mores on family size and the otherwise beneficial effects of increased longevity. And like other countries, to preserve these gains, Bermuda must now respond to these changes with policy reforms that encourage individuals to work longer, incentivize the retraining and employment of older workers as the work environment changes, and confront the challenges of an increasingly elderly population in need of additional caring services. Simply from the perspective of fiscal sustainability, the need for these changes is serious and urgent. They are necessary complements to a stronger revenue mobilization strategy.

55. Last year, we also raised an issue that bore more on the social sustainability of Bermuda's framework of social insurance. Even were there to be changes that would render the pension and health care systems financially sustainable, there is a risk of holes in the social framework. Under the present system, many of those wholly dependent on CPF pensions will fall below the poverty line, even before they bear the cost of health care premiums and copayments, not to mention the cost of FutureCare.[5] This will create pressures on the budget if as seems likely the social assistance system is forced to carry some of the burden. As we noted last year, "these questions raise issues of distributional equity, but cannot be avoided in any discussion of future budget priorities."

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5 Bermuda is not alone in facing such challenges. Even Japan, a country with a universal pension system, has one of the highest rates of elderly poverty among industrial countries.

H. Conclusion and recommendations

56. In our previous reports we have highlighted Bermuda's vulnerability to external events, as a small open economy competing in a global marketplace. We have pointed out a number of specific risks and uncertainties that could adversely impact the economy, in some cases possibly leading to a severe financial crisis affecting the wellbeing of all Bermudians. We have reassessed these risks in this report. Some can be and are being mitigated by determined government actions but while some of the risks we identified last year have diminished others remain or have increased and new ones will emerge. The high level of government debt and other contingent public financial liabilities leaves the island poorly equipped to deal with the potentially severe financial and economic impact if any one of these external risks were to materialise. Moreover, given likely future expenditure needs arising from an ageing population the government can ill afford to continue spending such a high proportion of its budget on debt service, which is currently the largest single category of government expenditure.

57. For all these reasons deficit and debt reduction should remain a high priority. We therefore welcome the new government's commitment to achieve budget balance by 2019 and to continue progress thereafter in reducing the volume of government debt accumulated in recent years so as to achieve the longer-term targets of reducing debt and debt service respectively to 80% and 10% of revenues.

58. Progress however has been mixed. In 2016/17 the fiscal deficit came out slightly lower than projected in the 2016 budget, with spending significantly below plans. The most recent fiscal plans for 2017/18 and beyond are those set out by the previous Minister in his 2017 budget. Relative to the plans set out in the 2016 budget these represent a significant degree of slippage, with a slowing of deficit reduction in 2017/18 and the target date for achieving budget balance pushed back from 2018/19 to 2019/20. Looking forward it is our understanding that the new government's present intention is to permit a larger deficit in 2018/19 than foreseen in the 2017 budget – albeit a deficit less than the contribution to the sinking fund thereby avoiding any increase in net debt - while sticking to the target of budget balance the following year. This further slippage for 2018/19 coming on top of the slippage in the 2017 budget is unwelcome; such slippage can easily become a bad habit.

59. Last year we said that the government's aim of increasing taxes by the equivalent of 2 ½ to 3% of GDP to achieve the fiscal targets was appropriate but would not be easy and that implementation would be a challenge. This is even more true today.

60. On expenditure the challenge will be to contain the total within the current allocation, absorbing the costs of new initiatives and the recently agreed increase in wages and salaries through increased efficiency. We welcome the government's intention to pursue increased efficiency with more determination than hitherto.

61. On tax the situation is more complex and the task more difficult. The former government introduced a reform of payroll tax giving it a degree of progressivity, which we welcome, and new taxes on banking and insurance. The intention was to meet its revenue targets for

2018/2020 largely through a second stage of the payroll tax reform and introducing a new General Services Tax. We understand that for the next fiscal year the new government may proceed with part of the planned further payroll tax reform and the introduction of new taxes on some professional services but intends to leave a decision on whether or not to introduce a full GST until it has the report of the new Tax Reform Commission which will not be before the summer of 2018. This is likely to leave a revenue gap to be filled in 2018/19 and we make a number of suggestions. We are disappointed that despite our clear recommendation last year that the Office of the Tax Commissioner should be provided with extra resources a number of posts subsequently approved remain unfilled because of failure to prioritise the necessary government recruitment processes. This is now a matter of urgency: additional resources for tax collection and enforcement should pay for themselves many times over in additional revenue.

62. Looking further forward, with the growing needs of an ageing population we believe that over the longer term the revenue share will have to rise from its current level of around 17% GDP to a level nearer the 22-23% share seen in comparable small island economies; this will be necessary both to ensure a stable and robust fiscal position and to accommodate future expenditure pressures. The work of the Tax Reform Commission is thus critically important. We make a number of suggestions.

- The current tax structure is excessively weighted towards the taxation of labour and goods and has the perverse effect of taxing companies that create employment while leaving those that do not largely tax free. Payroll tax becomes an increasingly problematic source of income as Bermuda's comparative advantage to international companies as a place to do business is eroded through reductions in rates of corporation tax elsewhere. It will be essential to look for sources of revenue that spread the burden more evenly across the economy.

- We continue to believe that a broader GST is needed as a way of spreading the tax burden more widely and raising revenue from the sector that is likely to be the fastest growing sector of the economy in future.

- The government is right to be concerned about the degree of inequity in the distribution of income and wealth on the island and like governments elsewhere should pursue fiscal measures that address the issue. This should involve the taxation of dividend income where dividends are being taken as a form of salary payment, some more general taxation of significant incomes from capital, as well as the introduction of greater progressivity in the taxation of labour and possibly also in public pension fund and social insurance contributions.

- The TRC would greatly benefit from knowledgeable and independent external advice, probably by building on the government's on-going cooperation with CARTAC. And it is clear that as we recommended last year, the capacity of the Office of the Tax Commissioner will need to be significantly increased, with a further increase in resources.

63. The government is also right to be looking for ways to bring faster economic growth to the island. We welcome initiatives to improve training and to diversify the island's economy by attracting new industries as well as building on existing areas of business. Faster growth will ease the

fiscal situation as well as improving the wellbeing of all Bermudians. As we have stressed in our previous reports, given demographic trends, it will be critical to success in these efforts to adopt an immigration policy and a welcoming attitude that encourages qualified and skilled people of working age (including returning Bermudians) to come to the island, whether as employees or to establish new businesses, and to stay. This will also help improve the sustainability of the island's pension and health insurance arrangements.

64. We also make recommendations about two policy areas that will be hugely important over the medium and longer term.

    - The island's costly healthcare system risks overwhelming the budget and the whole economy as the population becomes increasingly elderly and frailer, with more and more requiring long-term care. It will be important to pursue with determination measures now under consideration to control and reduce costs and to better target government subsidies to those in most need.

    - Both the public sector pension schemes and the Contributory Pension Fund remain substantially underfunded. It will be important to address this over time with a range of measures that should certainly include, as in other countries, a rise in the retirement age – a measure that also has the merit of increasing the working age population.

65. The new government thus faces a challenging agenda. We have been asked to continue our work and make a further assessment next year, and look forward to assessing progress then.

Annex A: List of Meetings Held by the Panel (December 4-7, 2017)

Association of Bermuda Insurers and Reinsurers

The Hon. Jeanne Atherden, J.P., M.P.

Jennifer Attride-Stirling, PS, Ministry of Health

M. Rozy Azhar, PS, Ministry of Home Affairs

Bermuda Bankers Association

Bermuda First Advisory Group

Bermuda Health Council

Bermuda Hospitals Board

Bermuda Monetary Authority

Bermuda Public Services Union

Bermuda Trade Union Congress

Bermuda Tourism Authority

The Hon. David Burt, J.P., M.P., Premier and Minister of Finance

Chamber of Commerce

Department of Statistics

The Hon. Patricia Gordon-Pamplin, J.P., M.P.

Nathan Kowalski (Economic Consultant)

Cheryl Lister (Consultant)

Ministry of Finance

The Hon.Wayne Furbert, J.P., M.P.

One Bermuda Alliance

Pension Commission

E.T. (Bob) Richards

Craig Simmons (Professor of Economics)

Senator Andrew Simons, J.P.

Robert Stubbs (Economic Consultant)

Tax Commissioner

Tax Reform Commission

The Fiscal Responsibility Panel
Peter Heller, David Peretz and Jonathan Portes