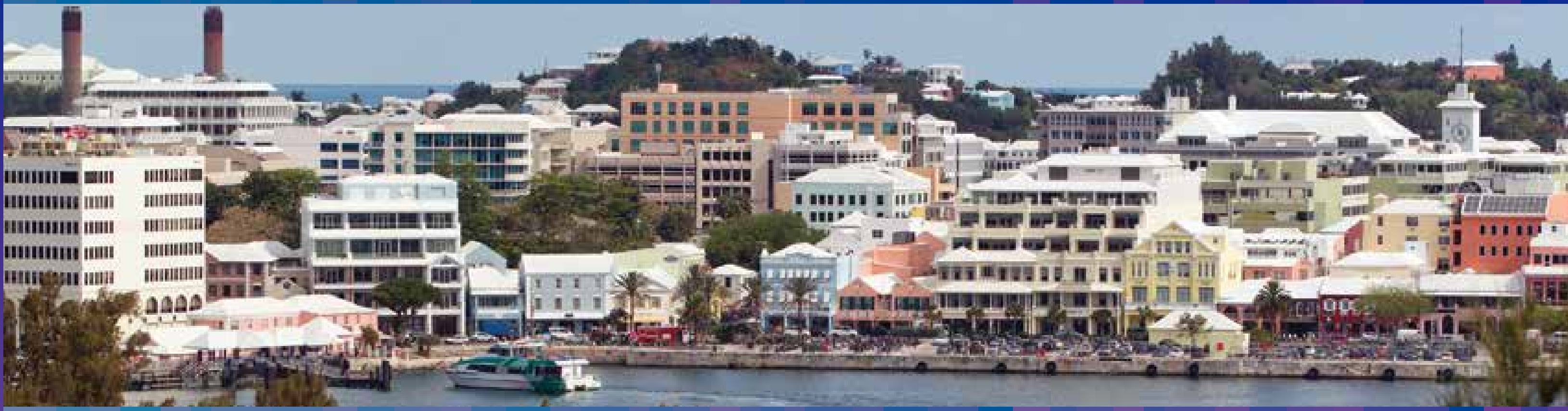
Fiscal Responsibility Panel



Bermuda

Annual Assessment 2015

David Peretz (Chair)
Peter S. Heller
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December 2015

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List of Acronyms

BHB: Bermuda Hospitals Board

BHC: Bermuda Health Council

BMA: Bermuda Monetary Authority

CARTAC: Caribbean Technical Assistance Center

COLA: Cost of Living Adjustment

CPF: Contributory Pension Fund

CPI: Consumer Price Index

DRG: Diagnostic Related Group

G20: Group of 20 Major Economic Powers

GEHI: Government Employees Health Insurance Fund

GDP: Gross Domestic Product

HIP: Health Insurance Plan

IMF: International Monetary Fund

MMLPF: Ministers and Members of the Legislature Pension Fund

MRF: Mutual Reinsurance Fund

MS: Morneau-Shepell, a private actuarial consulting firm

NPS: National Pension Scheme

MTEF: Medium-Term Economic Framework

OECD: Organization for Economic Co-operation and Development

PSSF: Public Service Superannuation Fund

SAGE: Spending and Government Efficiency Commission

SHB: Standard Health Benefit

VAT: Value Added Tax

Executive Summary

The Panel's remit 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 are 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, offering advice where needed on ways to refine these goals, and on adjustments to fiscal strategy and the tax and spending policies needed to achieve them.

This is our first annual report. While we have consulted many individuals and organisations we are an independent panel and the judgements and recommendations made are our own.

Bermuda's economy faces a number of risks and uncertainties, short term and longer term. The current level of government debt – taken together with very large potential liabilities from guarantees and underfunded public pension and health insurance schemes – risks turning the possible impact of any one of these into a serious setback for the island's economy. Reducing government debt and debt service costs are therefore a priority. Meeting the aim of a balanced budget in 2018/19 is appropriate, as is the aim of meeting the targets set for the ratios of debt and debt service to revenue.

Progress on fiscal consolidation so far has been cautious and incremental. While in the longer term the territory faces a major economic challenge from an ageing population, in the short term economic growth prospects over the next few years while still uncertain look better than for some years, supported by growth in the US and several major investment projects. This provides a window of opportunity to adopt the more aggressive approach needed to meet the balanced budget and debt targets. On stylized assumptions about growth and inflation, an additional fiscal tightening equivalent to around 2½% of GDP will be needed to meet the debt service or debt to revenue targets within 5 years of achieving budget balance in 2018/19. This we believe would be a credible timescale to set, and should be reassuring to the domestic public as well as to investors and capital markets. Hopefully it could gain at least a measure of broad support as a suitable fiscal aim for the island. This will also be important for credibility and external confidence.

The Government has already programmed in substantial spending reductions in its medium-term economic framework equivalent to around 2% of GDP by 2017/18. Achieving these will require making a visible start on a fundamental restructuring of government services, particularly as some of the short-term measures to contain spending taken to date will not be sustainable in future years. With Bermuda facing a serious demographic challenge, actions are also needed to address rising health costs and the underfunding of pension schemes that will cause increasing problems over the long term. These latter actions would involve early steps to adjust some of the terms and features of government pension and health insurance schemes, actions that will reduce their projected deficits. While much can be achieved without recourse to more public spending it seems unlikely that in the long run an increase in public spending can be avoided altogether. By cutting debt service costs (now approaching 20% of the national budget) debt reduction will open up much needed fiscal space to help deal with such pressures, although possibly not enough.

In acting to meet the debt targets within 5 years of 2018/19, sticking to existing programmed reductions in spending will itself be a major challenge particularly with likely future needs for additional spending. Thus, all or nearly all of the additional fiscal effort required after 2017/18 will have to come from revenue increases. We suggest that to allow for possible slippages in expenditures or revenues it would be prudent to target an increase in revenues equivalent to around 3% of GDP, implemented over the course of the three years starting 2016/17. This would raise the revenue to GDP ratio for Bermuda from 16% to 19%, still a low level compared to other similar jurisdictions.

The Government is currently considering the advice of the recent IMF CARTAC mission on options for raising additional revenue. It will be important to find approaches that so far as possible avoid damage to the island's most important industries; avoid placing extra burdens on the least well off; contribute to goals such as allocative efficiency, better health or a better environment; and that can be handled by the island's limited tax administration capacity. Structural changes such as the introduction of a broader consumption tax or a services tax to complement customs duties on imported consumer goods would take several years to implement, probably with a prior period of consultation. We therefore suggest a phased approach with immediate consideration given to steps that can be implemented in 2016/17. These might include beginning to phase out some customs and duty concessions, particularly those on some fuel imports and payroll tax concessions granted to the retail and hospitality trade; adjustments to customs and excise duties on petroleum products, tobacco, alcohol and possibly soft drinks; and initial steps towards reform of the payroll tax system.

Taken together with the already planned expenditure reductions this would constitute a balanced set of measures to address Bermuda's fiscal and debt issues, and such balance could help build the needed measure of broad support for the strategy.

Once decisions have been made, it will be important to monitor progress carefully. While we recommend setting out a clear target timetable for meeting the territory's debt targets, progress is unlikely to be smooth. Growth and/or inflation could turn out to be faster or slower than assumed in our illustrative scenarios, making progress easier or harder to achieve. So the strategy and speed of consolidation should be reassessed every year with policy adjustments made as needed.

In addition to these central recommendations, in the course of our report we make a number of detailed recommendations for consideration. They fall into the following categories:

- *The debt targets*. The debt and debt service to revenue targets are the important ones for Bermuda. We therefore suggest dropping the debt to GDP target, but if it is retained it should be set at a consistent level – around 15%. The longer-term rule of running a balanced current budget will also be useful once debt has been reduced to an acceptable level, although we suggest two minor modifications. Credibility would be further enhanced by action to limit future use of government guarantees.

- *The demographic challenge*. Policy should be designed to meet an objective that net migration of those of working age should be positive, significant and sustained by the end of the decade, and to encourage increases in the length of working lives.

- *Ways to contain and reduce spending*. It would help to establish a contingency reserve as a more efficient way to handle unexpected in-year spending pressures. Looking forward, to deliver the reductions built in to the Government's plans will require structural reforms in the way that services are delivered, and we make suggestions about the ways to go about prioritizing budget allocations, and strengthening the finances of the Government's pension and health insurance programs.

- *Ways to increase revenue*. We make a number of suggestions both for measures that could be implemented quickly and for possible longer-term reforms in the tax structure.

We look forward to making our next assessment in a year's time.

I. 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 are 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. In producing our first report we would like to thank all those who have offered us advice either in face-to-face meetings or otherwise (a complete list is in Annex A) and also to thank officials of the Finance Ministry for their technical assistance. However all the judgements and recommendations in the report are our own independent views.

3. The rest of this report is structured as follows. Section II sets out our view of the fiscal challenges facing Bermuda. In Section III we comment on the debt targets set by the Government – targets that in general we endorse as reasonable and prudent. Section IV assesses recent progress in meeting these targets. Section V discusses the desirable speed of future progress. Section VI discusses changes in tax and spending policies needed if the targets are to be met. While our focus is on short and medium-term issues, there are some major longer-term issues facing the territory as a result of an ageing population, underfunded pension schemes, and escalating health care costs, some of which require early attention: these constitute significant risks that would certainly "affect progress in meeting the territory's fiscal goals" and are the subject of separate Annexes B and C. Section VII summarises our main conclusions. We look forward to reviewing progress and making a further assessment in a year's time.

II. Bermuda's Fiscal Challenges

4. As a small, high-income economy largely dependent on financial services and tourism Bermuda shares many characteristics with a number of other similar economies. With a fixed exchange rate there can be no independent monetary policy[1]. And while the formulation of fiscal policy is likely to be less challenging when the economy is growing – and more challenging when the economy is contracting as in recent years – its macroeconomic impact may be much less important than the impact of shifts in the confidence of external investors. As a UK overseas territory Bermuda does not benefit from the kind of regular independent economic assessment provided for nation states of similar size by the IMF and other international bodies.

5. As the Government has acknowledged, like other similar small jurisdictions Bermuda faces a number of economic risks both in the short and longer term. The World Bank lists the following vulnerabilities common to many small states and territories:[2]

1 Experience in similar exchange rate regimes elsewhere nevertheless suggests that there could be circumstances when defending the exchange rate link with the dollar becomes an issue.

2 World Bank website, Small States Overview.

- “A high degree of openness means they are heavily exposed to external shocks in global markets.”
- “…their narrow resource base and small domestic markets prevent small economies from diversifying into a wide range of activities making them more vulnerable to terms of trade shocks. When one dominant activity declines it has an impact throughout the economy…”
- “Government revenues are also volatile…”
- “Small states lack …capacity to participate fully in international for a, which can profoundly affect their economies.”
- “…most are vulnerable to…natural disasters …that typically affect an entire population and economy”
- “Access to global capital markets is important….and one way to compensate for adverse shocks. But private markets tend to see small states as more risky than larger countries…”

To a degree Bermuda suffers from all these vulnerabilities. And the poor fiscal situation and level of public debt accumulated in recent years add a further level of concern.

6. Specifically, major risks to Bermuda’s economy include the following:

- *Uncertainties in the tourist industry*. Even before the 2008 downturn, Bermuda’s market share in tourism was in long-term decline. The industry should get at least a temporary boost from The America’s Cup in 2017 but improving Bermuda’s attractiveness as a tourist destination is likely to remain a continuing challenge thereafter given shifting patterns and preferences in the tourist trade.
- *Uncertainties in the financial service and insurance industries*. Insurance, particularly captive insurance and re-insurance business, and the wider financial sector including a small number of global banks, have constituted Bermuda’s dominant and most successful industry in recent years. These financial service businesses are now seeing growing pressure on profit margins which seem likely to persist for the foreseeable future. Moreover, such pressures may in turn lead to structural change – in particular consolidation in the insurance industry – which could have significant direct impacts on Bermuda’s economy.
- *Risks from global initiatives in financial regulation and tax cooperation*. One risk, the threat of action against jurisdictions offering opportunities for financial crime, appears to be being successfully addressed thanks to the efforts to upgrade Bermuda’s system of financial regulation and Anti-Money Laundering measures. A second comes from the global initiatives in place and being developed by the OECD (with G20 sponsorship) to counter tax evasion and avoidance. Bermuda has been labeled a tax haven in some quarters. This label can in itself be damaging despite the strong and effective efforts by Bermuda to counter it, affecting the willingness of some other countries’ governments to pay attention to Bermuda’s concerns, and the willingness of some businesses based in those countries to work with Bermuda-based companies. Sensibly applied and with continued full cooperation by Bermuda, the G20/OECD initiatives should have little impact on Bermuda’s financial services sector, but there is no certainty here and there may be additional risks from further unilateral measures being taken by some OECD countries.
- *Events in global capital markets*. With its high level of government debt with relatively short maturities Bermuda is of course vulnerable to the likelihood of rising dollar interest rates. With debt interest already accounting for 13% of the annual revenues it is easy to see this could by itself lead to further downgrades by rating agencies. Some other external event, such as problems in

another similar island economy or the impact (perceived or real) of OECD tax initiatives, could also have a similar effect. Such a downgrade would not only impact on the Government's borrowing costs and put further pressure on its already stressed budget – it would also have likely negative implications for financial businesses operating in the territory. Moreover, some shocks (or combination of shocks) might lead not just to higher borrowing costs, but to complete loss of market access. This would (by definition) oblige the Government to move immediately to a position where all expenditures, including debt service and refinancing of maturing debt, are financed from current revenues.

- *Impact of global warming and climate change.* Bermuda has always been vulnerable to weather events such as hurricanes that impact the whole territory. With global warming such extreme events are becoming more frequent. And in the longer term there will be the impact of rising sea levels to consider and adapt to.

- *Effects of an ageing population, declining workforce and escalating health care costs.* This also is a certainty, not just a risk, which will result in serious longer-term pressures on public spending and challenges to growth, as discussed more fully in Annex C. Concern about this and the current degree of underfunding of public sector pension funds (see Annex B) is a further factor that could trigger a downgrade by rating agencies, as has happened elsewhere.

There are of course many other uncertainties, including the risk of future unforeseeable events in the global economy.

7. Given these uncertainties and risks, the build up in public debt in recent years is a serious concern, especially as much of the debt will mature in the next few years. Charts 1a and 1b show just how rapidly debt and the various key debt ratios have risen from historically much lower levels. And the figures in the charts relate only to central government debt. In addition to central government debts of some $2.1 billion, government guarantees of $535 million have been issued for borrowing by other public and private sector undertakings, with further guarantees committed but not yet signed – bringing total government exposure towards $3 billion. And public pension and government health insurance schemes have unfunded liabilities of somewhere between $1.5 and $4 billion, representing a further potential future claim on government financial resources.

8. In these circumstances, we therefore believe the Government is right to have committed to achieving budget balance (on the Government's preferred definition) by 2018/19, and thereafter take further steps to reduce net debt. Even the first step, achieving balance by 2018/19, is an ambitious target. As discussed below, it will not be achieved without further measures to raise revenue and/or curtail expenditures. Sections V and VI below comment on the desirable speed of progress, prospects for growth, and options available for fiscal tightening. First, however, we offer some comments on the longer-term debt and fiscal targets the Government has set.

III. The Government's Debt Targets

9. Meeting the objective of achieving a balanced budget by 2018/19 would allow a net *reduction* in debt that year of the size of the sinking fund contribution, around $57 million – still quite a small reduction in relation to net debt that will by then total over $2.3 billion. The Government has also set objectives for a net debt/GDP ratio of 38%; reducing net debt and debt service to less than 80% and 10% of revenues; and in the longer term implementing the rule that net borrowing can only be considered for the financing of capital expenditure.

10. Debt/GDP is a conventional measure used for larger economies, with GDP giving a measure of the taxable capacity of an economy and hence of a government's ability to service its debts. Debt and debt service to revenues are however in some ways more appropriate measures of fiscal sustainability for jurisdictions like Bermuda with low levels of taxation, with significant sections of the economy that are difficult or impossible to tax at a much higher rate, and which cannot afford the pressure that high expenditure on debt service puts on finance for government services. To illustrate, in 2017/18 debt interest is projected to account for 13% and total debt service (including the Sinking Fund contribution) to account for nearly 20% of government revenues.

Chart 1a. Growth of Net Government Debt

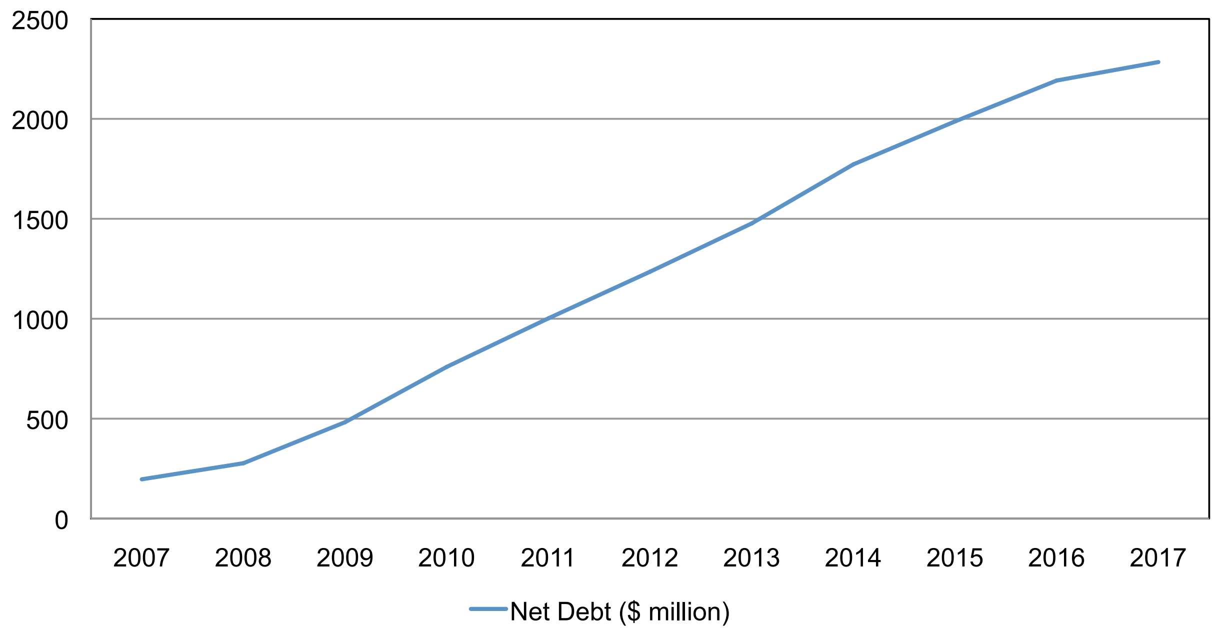
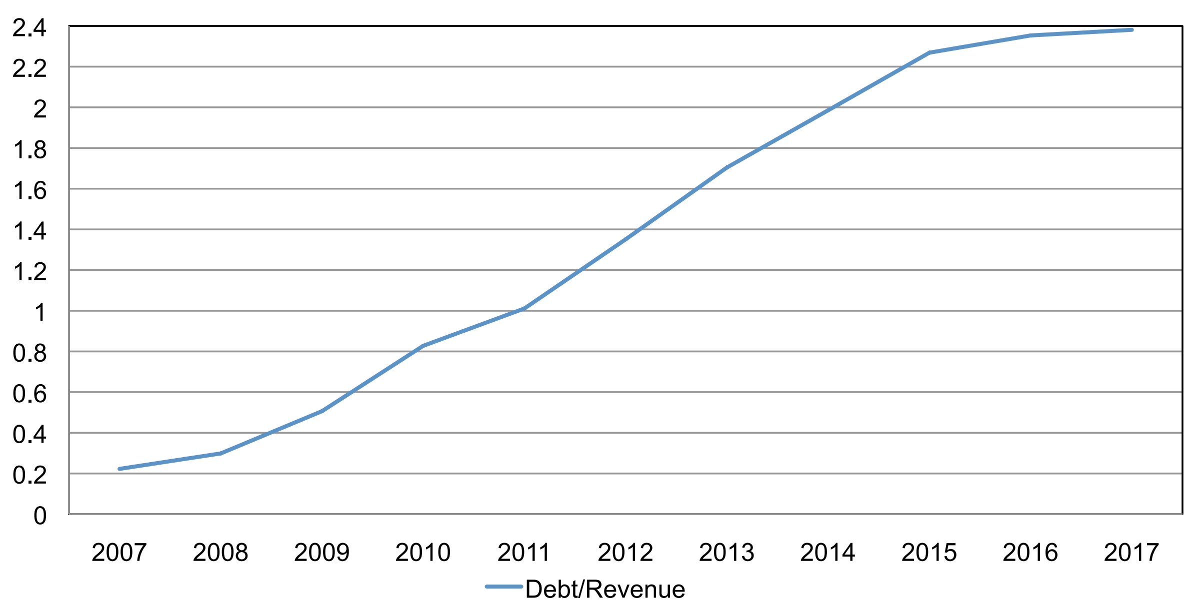
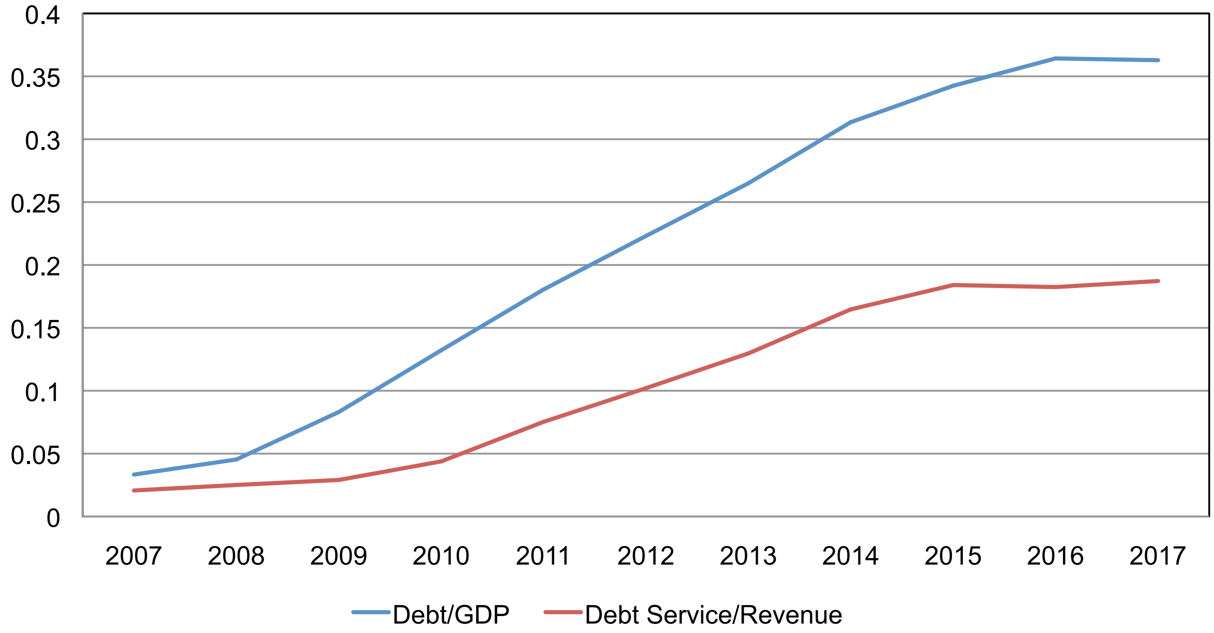


Chart 1b. Changes in Key Debt Ratios





The three ratios currently set are however mutually inconsistent. Most importantly, at current levels of revenue, the debt to revenue target ratio of 80% equates to a debt/GDP ratio of around 13%. And the debt to revenue and debt service to revenue targets would be equivalent if the average interest rate on debt were 10 percent: at current interest rates, it is the debt to revenue target that is binding. It is clear from Chart 1b that there is a long way to go before Bermuda can meet that target.

11. Given the nature of the territory's economy and the uncertainties and challenges it faces in the future we believe that debt and debt service to revenue ratios of 80% and 10%, represent appropriate debt limits to set for Bermuda. As noted, while average interest rates remain below 10 percent it is the 80% debt to revenue target that is binding. We suggest that the debt to GDP target be dropped, but if it is retained it would be consistent to set it at around 15% of GDP[3] (if taxes were to be raised to a level of 20% of GDP then a consistent debt/GDP limit would be 16%). Attaining the debt to revenue target (or a consistent debt/GDP target) will require a reduction of more than half from current levels of debt even after allowing for future growth and inflation. Table 1 shows current and target ratios in a number of other territories with similar characteristics.

12. It could be argued that as long-term goals these targets are insufficiently demanding, given the scale of borrowing by other public bodies, government guarantees and unfunded future liabilities in public pension and health insurance schemes; and the risks, in particular of loss of market access to finance, identified above. So there is a case for going further, and like some other similar territories aiming first to reduce net central government debt to zero, and then over a period accumulating net assets that could be drawn on in times of difficulty – though some of the benefits could also be obtained by lengthening the maturity of borrowing and at the same time maintaining a larger reserve of liquid assets to be drawn on if needed. That could be a sensible strategy to consider as net government debt is reduced. In any event, once the targets are reached it would be advisable to take opportunities to reduce debt further to leave space within the limits for debt to rise again in the case of future unexpected shocks.

3 Interestingly, 15% of GDP is the limit that the island of Guernsey has set for itself, though in fact Guernsey remains in a net asset position.

Table 1 Debt and Fiscal Rules Adopted in Similar Jurisdictions

	Annual Budget	Government Debt	Current Position
Guernsey (rules adopted in 2009 updated in 2011)	Maintain long run "permanent balance" in budget. Annual deficit never to exceed 3% GDP and any deficit to be removed within 5 years of first appearing.	Total debt never to exceed 15% GDP, and borrowing only to finance capital spending.	No debt. Continuing deficits financed by drawing down accumulated reserves.
Jersey (rules adopted in 2007, updated 2014)	Maintain balanced budgets over medium term for current expenditure.	Only draw on stabilisation fund (accumulated reserves) as advised by Fiscal Policy Panel	No debt. Continuing deficits financed by drawing down accumulated reserves
Cayman Islands (rules updated in 2011)	Run surpluses for a number of years to reduce debt by 2016	By 2016: net debt below 80% government operating revenue ; debt service below 10% government operating revenue; liquid assets at least 25% government operating expenditure.	On course to exceed 2016 targets and then to reduce debt further. 2015/16 budget estimates reaching net debt/revenue ratio of 47.6% with operating revenue at 25% GDP
Curacao and Sint Maarten (rules adopted in 2010)	Balanced current budgets	Debt to be less than 35% GDP. Interest to be less than 5% fiscal revenues. Borrowing only to finance capital spending. Arrangements giving Netherlands government some control.	Debt to GDP and interest to revenues ratios reduced substantially in recent years by increased revenues and now comfortably below limits in both territories.
British Virgin Islands (rules updated 2012)	Run surpluses for number of years to meet liquid asset ratio by 2016	Net debt below 80% and debt service below 10% of government operating revenue. Liquid assets of 25% operating expenditure	On course to meet liquid asset target. 2015/16 budget estimates net debt/revenue ratio of around 35% with annual operating revenue around 30% GDP
Gibraltar (law updated 2008)	Balance current budget	Net debt to be under 80% and debt service under 8% of recurrent revenue. Net debt to GDP not more than 40%.	Reports continued compliance with rules. Government annual operating revenue around 40% GDP

13. Achieving these targets will necessarily require a more ambitious pace of budgetary consolidation with judgements to be made about how rapidly to proceed, and we discuss the options in the following section. At the same time we think that it would help bring about a better public understanding of the issues if the Government could provide a more transparent presentation of the overall fiscal

and debt position. In part, this would mean summarising in one place in the annual budget statement information on the scale of the debts of other public bodies, the extent of unfunded liabilities in public sector pensions and health schemes, and the amount of government guarantees. While these liabilities are less "hard" than formal government debt, neither can they be downplayed in terms of the fiscal pressures they might give rise to in future years if not addressed by other measures in the meantime. Current efforts to provide a more consolidated picture of the Central Government's financial flows (inclusive at least of the public sector pension funds, the Contributory Pension Fund (CPF), and the Government Employees Health Insurance (GEHI) Fund) would also provide greater transparency of the Government's overall fiscal policy stance and aggregate liabilities[4].

14. Finally, we believe the longer-term rule put forward in the 2015/16 budget statement, essentially requiring a balanced current budget, is broadly appropriate once the immediate fiscal sustainability concerns have been dealt with. However, as made clear in the budget statement, in the near term a more ambitious approach is required – in other words the Government will need to run an overall surplus for a number of years – in order to reduce debt to an acceptable level. When the longer-term rule is eventually implemented we suggest two minor modifications. First, it would be normal for such a rule also to require a contribution to cover capital depreciation. Although not exactly designed for the purpose we suggest that continued contributions to the sinking fund could be taken to cover this. Second, we suggest that the rule should be applied over a period of years rather than year by year, to allow flexibility in reacting to unexpected negative or positive fiscal shocks.

IV. Assessment Of Current Progress In Meeting Fiscal Policy Objective

15. Recent progress in reducing the fiscal deficit has been relatively slow. The 2014/15 Budget Estimate was for an overall deficit (after capital expenditure and the sinking fund contribution: Box 1 explains the definitions of deficit and debt service used in Bermuda) of $267 million, down from $333 million in 2013/14; the current deficit in 2014/15 (before capital expenditure and the sinking fund contribution) was planned to be $158 million, reduced from $233 million. Deficit reduction was to be achieved mostly by reductions in spending, which was to fall by about $70 million, or 7%, in cash terms, while revenue was projected to grow only slightly. This was originally intended to be part of a Medium Term Expenditure Framework (MTEF), under which spending would fall by a further 5% in 2015/16. Given that staff costs account for close to half of current (non-interest) spending, and both the Government and trade unions wished to avoid job losses, a significant proportion of the reduction was to be achieved by a "furlough" policy, agreed with the unions, under which public sector workers were obliged to take a day of unpaid leave every month.

16. The spending reductions were largely delivered as planned. However, there was a significant shortfall in revenues, in particular customs duties, which materialised at the end of the financial year; revenues overall in fact fell in 2014/15 compared to the previous year. Overall, the actual outturn for the current deficit in 2014/15, before capital expenditure and the contribution to the Sinking Fund, is now estimated at $193 million, meaning the overall deficit was about $300 million. In other words, the 2014/15 deficit was only about 10% lower than that for 2013/14 compared to the 20% reduction originally planned.

17. After this modest reduction, the 2015/16 Budget envisages a significant increase (more than a doubling) in the pace of fiscal consolidation, with a planned deficit of about $220 million, a reduction

4 Box 3 below provides estimates of the unfunded liabilities of these public pension and health insurance funds. Alternative measures of the financial position of these pension and insurance funds could also be presented, such as the length of the time during which their projected assets can finance projected outlays.

Box 1

Deficit and debt service - definitions

Bermuda, for the purpose of presenting its Budget and for formulating its fiscal targets, uses rather different definitions to standard textbook or international definitions. These particularly relate to the treatment of contributions to the "Sinking Fund". There is nothing wrong with this provided these definitions are explained clearly and transparently.

Deficit

The standard international definition of the deficit is, broadly, the excess of all government expenditures (including spending on investment projects and spending on interest payments to service government debt) over government revenues. Consequently, transactions within government – payments from one government account to another – do not add or subtract from the deficit. Bermuda differs in that contributions to the "Sinking Fund", which are an intra-government transfer, add to the deficit. Consequently, "balancing the budget" or "eliminating the deficit" is more demanding on the Bermudian Government definition than the standard international definition.

Current deficit

The standard definition of the current deficit is the deficit excluding net investment. That is, it is the excess of current (non-investment) expenditures over current revenues, plus an allowance for depreciation (a non-cash expense) of the capital stock owned by the Government. The Bermudian Government definition differs in two respects; first, as above, contributions to the Sinking Fund add to the current deficit; second, no depreciation is recorded on the public sector capital stock. These differences go in opposite directions. Although, absent detailed accounts, we do not know which is larger, it could be argued that the treatment of Sinking Fund contributions is a rough and ready way to offset the non-recording of depreciation in the Government accounts, and hence that overall this treatment appears reasonable, in particular for the Government's long-run target of current balance.

Debt service payments

Debt service payments are normally considered to be the payments made on (gross) government debt. However, as above, and for the purposes of the government's target to reduce debt service payments as a proportion of revenue, contributions to the Sinking Fund are treated as debt service.

Throughout this report we use the government definitions. As noted above, they are in general at least as stringent as the standard international ones.

of about $80 million. There is also a rather different balance between tax and spending measures. The agreement with the public sector unions, and with it the furlough programme, expired at the end of 2014/15, and negotiations to extend it have so far been unsuccessful.

18. This has made it significantly harder to reduce spending, and it is planned to reduce expenditure by a further 3.5% (rather than the 5% envisaged in the MTEF), with the lost savings from the furlough being substituted with a variety of smaller measures, including a hiring freeze and a cap on the Financial Assistance programme. Meanwhile, there is a greater reliance on tax increases, with increases in the payroll tax and on customs duties on fuel, as well as a variety of smaller measures. Deficit reduction in 2015/16 is therefore roughly balanced between tax and spending measures in nominal terms, although with modest inflation this still probably represents greater reliance on spending restraint.

19. So far this year, revenues appear to be broadly on track, increasing by about 4.5% in the first half of the year compared to the previous year. However, while current expenditure is roughly flat, and appears to be broadly in line with budget projections so far this year, spending pressures are emerging within Departments. The Government has taken the view that additional actions are required to ensure that there is no spending overshoot, and has therefore introduced a number of measures, including a tightening of the hiring freeze already in place.

Assessment

20. The picture is therefore mixed. It is clearly positive that Bermuda has succeeded in reducing the deficit, despite the pressures on both revenues and spending from the recent sluggish economic performance. While expenditure reductions have obviously been painful in some areas, it is also positive that initially efforts were made to engage the support of trade unions in the endeavour (and regrettable that the initial cooperation appears to have broken down). And financial management has so far delivered expenditure reductions albeit less than had been planned.

21. However, progress to date has mostly been the result of a step-by-step incremental approach on both the tax and spending side. That is, revenue increases are being delivered by modest increases to tax rates, while leaving the underlying structure largely unchanged and without broadening the tax base significantly. Spending reductions were first implemented largely through the furlough programme (again, leaving the structure and composition of public sector employment largely unchanged although the reduction in the aged subsidy did somewhat shift the balance of spending) and now through a variety of smaller measures.

22. The limitations of this approach are shown both by the breakdown of negotiations with the trade unions on the furlough, and the repeated reliance on ad hoc measures like the hiring freezes and the suspension of government contributions to the Public Service Superannuation Fund (PSSF). Such measures are unlikely to be either sustainable or efficient beyond the short-term. In particular, as the Government recognises, the suspension of contributions to the PSSF reduces the deficit in the short term, but since it does not directly affect the future gross liabilities of the Fund, the result is an offsetting increase in the net unfunded liability; there is no net impact on the Government's finances in the long term. The fact that the Government has been obliged to introduce further such measures in the course of this financial year to deal with overspending in some departments is a further demonstration of the limitations of this approach.

23. This suggests that while the approach to date has been necessary in the short-term to avoid a progressive deterioration of the overall position (and the loss of confidence, both domestically and on the part of international investors, that would have been likely) it is not likely to be either viable or sufficient over the medium term.

V. Desirable Speed of Future Progress

Economic prospects and background

24. Before discussing possible strategies for fiscal policy, it is important to place Bermuda's policy in the larger context of the global economic environment within which the territory must operate. In the past few months, prospects for the world economy have worsened slightly. The IMF has reduced its forecasts for global growth for both 2015 and 2016, projecting growth this year at 3.1%, slower than at any time since the financial crisis. This is mainly due to a slowdown in large emerging market economies. This in itself is unlikely to have significant implications for Bermuda, since its direct links to emerging markets are small. However, of greater concern are the key downside risks identified by the IMF. Two, in particular, should be noted:

- **the likelihood of a rise in US interest rates** has risen significantly (and indeed long-term interest rates have already begun to rise). This will lead to higher yields on debt issued by dollar debtors such as Bermuda. And while it may raise the profitability of banks and insurance companies, if reflected in mortgage rates it will place a further strain on household finances, particularly those of lower-income homeowners.
- **greater financial market volatility.** Equity markets have been highly volatile in recent months. Government debt markets have been more stable, but spreads between US Treasury and high-quality corporate bonds (which is how Bermuda government bonds trade) have also risen. While this does not as yet jeopardise Bermuda's access to markets, there is considerable uncertainty, and sharp reversals in capital flows cannot be ruled out.

25. Developments in the US economy over the next year will clearly be important. But it could be argued that Bermuda, in common with many other small open economies, is caught between a rock and hard place; if the US recovery continues more or less as forecast (that is, at a modest pace, but faster than most other developed economies, and stronger than large emerging economies) then a rise in US interest rates, and possibly the dollar, is likely, possibly as soon as December; this will have implications for Bermuda's ability to fund its debt at the current, historically low, level of interest rates. If, on the other hand downside risks materialise and the US and global economy prove significantly weaker than forecast, then US interest rates may rise more slowly than expected and long-term interest rates will probably remain low. But financial market volatility will continue and there will also be implications from the weaker global economy for tourism and trade. Worse still, the prospect of a general increase in risk aversion makes it possible that credit spreads will widen, again pushing up interest rates paid by borrowers like Bermuda, and in the worst case jeopardising Bermuda's access to capital markets. Neither of these scenarios is appealing.

26. On the positive side, the fall in oil and other commodity prices improves Bermuda's terms of trade; it should also have some indirect benefits (if, for example, it leads to lower air fares, which will benefit the tourism sector).

27. Assuming that developments in the US economy are as forecast, Bermuda's short to medium-term growth prospects appear to have improved somewhat. The economy appears to have returned to growth, albeit sluggishly and driven primarily by increased compensation to employees in the international business sector. As yet there is little sign of a broad-based pickup in either private consumption or investment, which will be required for sustained and healthy growth. However, a number of major investment projects are likely to come on stream over the next two years, and – provided that these do in fact materialise in a timely fashion – with ample spare capacity (unemployment remains at a historically elevated level) there should be scope for sustained non-inflationary growth at a reasonable pace. The insurance sector, which is by far the largest contributor to exports, remains healthy.

28. In the medium term, there are two major challenges, relating to the two major industries:

- Substantial new investments in tourism-related projects, including The America's Cup, the new airport, and several large private hotel projects will support growth in the short term, as money is spent on constructing new infrastructure. But this will only be sustainable if the investments help boost tourism numbers going forward – if in fact they attract high value luxury hotel visitors (as opposed to relatively brief stops by cruise ships). Smart and agile efforts at marketing and exploitation of Bermuda's tourism assets are critical in this fast-changing global tourism environment (with new low-cost competitors such as Cuba).

- The need to maintain an environment attractive to insurance and other financial business, which constitutes at least a quarter of GDP directly (and significantly more indirectly). As noted above, this requires the continued maintenance of a sound and respected system of regulation, and cooperation with international initiatives to tackle tax evasion and artificial practises by companies designed to avoid tax. Bermuda is generally respected internationally for the quality of its regulatory framework; but it will need to be proactive in order to maintain this in a rapidly changing international environment. In addition, structural changes in the insurance industry mean that Bermuda may need to establish a position in new, but related markets (for example insurance-linked securities) to preserve its market position.

29. Bermuda also faces a very serious demographic challenge, which will have increasingly significant implications for both economic and fiscal policy. This is driven by low fertility, negative net migration, and increasing life expectancy as the baby boom generation moves towards retirement. The combined impact means that, on current projections, Bermuda can expect to see a fall in its working-age population, and a sharp rise in the dependency ratio, which is forecast to rise from 19% in 2010 to 30% in 2020. The speed of this transition is very rapid by international standards. By contrast, the US – which started this decade in a roughly comparable position – is not projected to hit the 30% mark until almost 2030.

30. The challenges this poses for economic strategy are difficult to overstate. The working-age population is projected to shrink by more than 9% in the period 2010 to 2020, with this decline continuing thereafter. Other things being equal, this will be a very considerable drag on growth. If no action is taken, the risk is of a vicious circle; a lower working-age population leads to a lower tax base, which in turn requires higher tax rates and/or lower quality public services just to maintain fiscal sustainability; this in turn increases net emigration, especially of younger skilled workers, further worsening the position. Meanwhile, the increase in the retired population inevitably leads to greater pressures on government expenditure, off and on balance sheet, particularly in the health sector; while the increased weight of the retired population in the electorate means that it becomes more and more difficult to restrain spending.

31. Increased immigration – and reduced emigration – of younger, skilled people of working age would contribute directly to alleviating several of the issues above. It boosts growth directly, by adding to the working-age population; to the extent that migrants are more skilled than the local population, they will also boost productivity; and a larger and more productive workforce will in turn generate higher tax receipts, both directly through payroll taxes and indirectly. The Government has already taken significant steps to liberalise immigration policy in respect of work permits and Permanent Residence Certificates, which is welcome. Further moves in this direction, for example to ensure security of residence for skilled migrants and eventual access to permanent residence rights or the equivalent, would provide a further incentive for skilled migration, as well as providing some trade off for the higher taxes that are almost certainly going to be needed and allowing business greater certainty in workforce planning, which in turn should encourage investment. At the same time, it is equally important to reduce emigration of Bermudians, especially of younger and more skilled citizens (and to attract back recent emigrants); clearly here the most important factor by far

is employment opportunities. Overall, a significant turnaround in the migration statistics is highly desirable. It would be sensible to set an objective that net migration of those of working age should be positive, significant and sustained by the end of the decade.

32. Meanwhile, increases in life expectancy, especially healthy life expectancy, are wholly welcome; but efforts should be made to ensure that they are accompanied by increases in working lives. Policy actions that could assist include removing incentives to early retirement in private pension systems (and in public systems once their aim of helping bring about a reduction in the workforce has been achieved) and raising the age of normal pension entitlement in line with increases in healthy life expectancy.

Implications for fiscal strategy

33. The above analysis suggests that Bermuda has a window of opportunity, presented by the return to growth domestically, continued economic recovery in the US, and the boost from several major investment projects. This window offers the chance both to put Bermuda's two major industries on a sound footing for the future, and also to restore fiscal health. But it is a window that could close at any time were there to be a material worsening in financial market conditions for borrowers like Bermuda. It is also essential to take advantage of this opportunity before the effects of demographic change become serious.

34. For fiscal policy, this means that action is required immediately to put the fiscal accounts on a credible and sustainable path. Early action will have a number of positive impacts:

- **On public confidence in Bermuda's future:** the current uncertainty about future economic prospects and public service provision is damaging and divisive. A clear, credible and convincing plan – even involving some sacrifice – could help restore the position.

- **On investor confidence:** foreign direct investment, in particular, needs assurance of a reasonably stable economic environment, and in particular that it will not be necessary to increase taxes very sharply in the future; much better to set out a credible programme, while signalling any necessary tax changes in advance.

- **On Bermuda's position in financial markets:** if a significant financial market shock does occur, it will be far easier for Bermuda to refinance its debts at reasonable rates if the deficit is falling sharply, and there is a credible plan for it to continue to fall. This is the case even if the debt overall still remains high relative to revenues in the short term – the key point is the need for a credible plan.

- **On the feasibility of addressing the longer-term challenges of demographic change:** it will be much easier, both economically and politically, to deal with these issues if action is taken now, to reduce debt and debt interest and to restrain the growth in the long-term costs resulting from an ageing population.

35. There are, of course, legitimate concerns about the impact of a sharp fiscal tightening on growth, particularly as Bermuda is only just now emerging from a prolonged period of stagnation. However, we believe these are unlikely to be overly serious, for the following reasons:

- private direct investment, particularly from abroad, is a key driver of growth and employment. A credible fiscal strategy should bolster this, compensating at least in part for the drag on growth from fiscal consolidation.

- Bermuda is a very small and relatively open economy. Imports account for about a third of GDP (and exports for about half of GDP). Fiscal multipliers – that is, the impact of fiscal consolidation on GDP growth – should be relatively low, compared to larger economies like the UK.[5]

36. Nevertheless, in purely financial as well as economic and social terms, fiscal consolidation will undoubtedly be easier in a period of economic growth when revenues are likely to be more buoyant and some spending pressures (for example, Financial Assistance payments) can be reduced; in general, the path of fiscal consolidation now and in the future should reflect economic conditions. Given the relatively benign economic outlook in the short term, this suggests that it would be appropriate to plan on reasonably rapid consolidation now, while being ready to review progress in the light of economic developments and make policy adjustments if needed. In particular, if growth is stronger, it could be appropriate to move faster. If it is weaker, it might be appropriate to move more slowly, although this would depend on the source of the weakness.[6]

Assessing the Government's fiscal strategy

37. Against this background, we assess a number of possible scenarios (not forecasts) for the path of fiscal consolidation and hence of the public finances and public debt. As noted above, in addition to confirming long-term debt targets, the 2015 Budget also sets out an intention to balance the overall budget, after taking account of both capital spending and Sinking Fund contributions, by 2018/19. It also sets out fiscal plans through 2017/18. These assume that spending falls a further 5.6% in 2016/17 and is then flat; while revenue grows at 3% annually (the key macroeconomic assumptions for later years underlying the scenarios are noted in Box 2). This would represent a further significant fiscal consolidation, entirely reliant on spending reductions – current spending as a proportion of GDP would be reduced by a further 2% (from about 16% in 2015/16 to about 14% in 2017/18). This is probably approaching the limit of what is feasible and sustainable on the expenditure side.

38. Our **first scenario** takes the Budget plans and the commitment to balance in 2018/19 as given. After that, it assumes that the budget remains in balance – that is, that the debt is reduced each year only by the amount of the Sinking Fund contribution. This strategy would allow the debt/revenue target to be hit but not until 2034 (the debt service to revenue target would be met a few years earlier, unless there was a major rise in interest rates).

39. However we doubt whether the trajectory set out in the Budget is entirely realistic. It assumes that after a relatively small fiscal tightening in 2017/18, there is then a very sharp contraction in 2018/19, amounting to about 2% of GDP. This seems implausible without major structural change, and even if there were a structural change, for example in the tax system, it would seem better for the economy to avoid such an uneven profile. It is also worth noting that even if the profile of adjustment to 2018/19 were smoother (that is, that consolidation were faster in 2017/18 and slower in 2018/19), this would not make achievement of the longer-term targets significantly easier (they would be met at most a year earlier, if that).

5 We note the SAGE Commission referred to an estimated multiplier of 1.28, which would imply a marked negative impact on GDP growth from fiscal consolidation, although the methodology underlying this estimate is unconvincing. There is considerable work by the IMF that suggests fiscal multipliers, particularly for taxes or current spending, are relatively low in small island economies. For example, "Fiscal Multipliers in the ECCU", IMF Working Paper WP/13/117, found that long-run tax and current expenditure multipliers were not significantly different from zero (with point estimates of perhaps 0.3 to 0.4). See https://www.imf.org/external/pubs/ft/wp/2013/wp13117.pdf

6 That is, in some circumstances, while slower fiscal consolidation might be appropriate from a macroeconomic perspective, it might simply not be feasible if that would jeopardise market and investor confidence.

Box 2

Assumptions and risks underlying the policy scenarios

The key risks relating in this analysis are GDP growth and interest rates. We assume that GDP grows by 4% annually in nominal terms (2% real growth, and 2% inflation). For the reasons set out in paragraph 27, this seems a reasonable central projection in the short term, although if action is not taken to address the demographic challenges, it may be over-optimistic for the medium to long term as regards growth. As an illustration, were nominal GDP to grow by 3%, and this to translate into reduced revenue (and to some extent spending) this would delay the achievement of the debt/revenue target, in our preferred scenario 3, by about 2 years (to 2025/26).

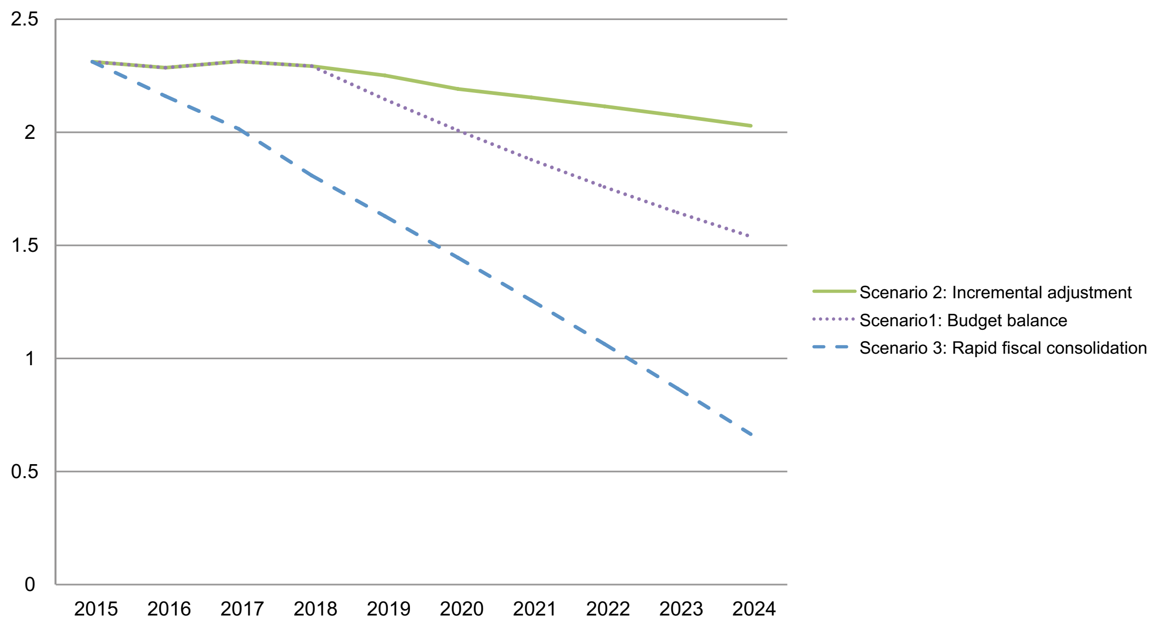
We assume that nominal interest rates on outstanding Bermudian Government debt remain at 5.5 percent. This is higher than current market yields of about 4.7 percent (the difference reflects the fact that much of the debt was issued at a time when market rates were higher). As noted above, there are both upside and downside risks to this assumption, depending both on the course of US long-term interest rates and financial market confidence in Bermuda. In the short term, changes to interest rates payable on newly issued debt would make only a relatively small difference to the projections described above. The key point to note here is that while a rise in the rates paid by Bermuda to borrow in the market resulting from general financial market developments will have some impact, it is likely to be manageable; the key (and unquantifiable) risk is a loss of confidence in Bermuda's fiscal and economic position resulting in a complete loss of market access.

40. For comparison, we model a **second scenario**, of "incremental adjustment," which assumes that policy continues along more or less the current course, of expenditure restraint, combined with modest revenue enhancement, but without major structural change. We assume the figures set out in the Budget to 2017/18, followed by annual revenue growth in line with GDP (4% nominal) and spending growth of 2%. This would not achieve a balanced budget on the Government's definition until 2033. Under this scenario, the debt/revenue target would not be hit until 2041.

41. Clearly, neither of these two scenarios appears either credible or in line with the Government's aspirations. Finally, therefore, we illustrate a **third** scenario of a strategy which assumes a relatively aggressive approach to debt reduction, beginning in 2016/17 and continuing in the following two years to deliver an additional fiscal adjustment over the period amounting to around 2½% of GDP. If the additional adjustment were all achieved by revenue increases, the revenue/GDP ratio would rise from its current level of about 16% to about 18.5%. This would require revenue-raising measures contributing an extra 5% a year over a three year period, on top of the 4% a year growth assumed to result from the 4% annual growth in nominal GDP. This boost to revenue allows spending to rise by 2% (in line with inflation) in 2018/19, while still giving a small overall surplus. After that, both spending and revenue grow with nominal GDP; however, since spending will at this point be significantly less than revenue, the surplus grows. This scenario allows the debt/revenue target to be met 5 years after first eliminating the deficit in 2018/19, in 2023/24 (with the debt service/revenue target hit in 2021-22)[7].

7 We do not show the path of the other targets (debt/GDP and debt service/revenue); the debt/GDP is the most demanding target under all scenarios.

Chart 2: Debt/revenue under different scenarios



42. The chart shows the very large differences between the scenarios resulting from the frontloading of revenue increases in the "rapid consolidation" scenario. Of course, in practice the profile of revenue increases could and would be staggered, and these scenarios are purely illustrative. The key point here is that achieving the Government's stated fiscal targets within a reasonable timescale is likely to require a substantial, but not unachievable, additional fiscal adjustment, probably amounting to about 2½% of GDP (around $140 million in current prices), largely achieved by increasing revenue. Given pressures on expenditure, and the need to allow for slippage in both expenditure control and revenue increases, this argues for targeting an increase in revenue in gross terms of perhaps 3% of GDP.

43. We believe that this is a realistic and credible goal. By focusing most of the additional adjustment, beyond what is already planned on spending, on the revenue side, it recognizes the fiscal, economic and social realities of the current position; and by enabling the Government to meet the debt/revenue target within 5 years of balancing the budget, it would, we believe, provide a credible timescale and should be reassuring to investors and capital markets. But the achievability and credibility, both domestic and international, of such a plan will depend also on securing at least a degree of consensus domestically on the feasibility and desirability of such an approach, and we hope this can be achieved. Credibility could be further enhanced by parallel action to limit any further potential government provision of guarantees; and actions to begin to address the various challenges of an ageing population including the underfunding of public pension funds and reform of healthcare financing as discussed further below.

VI. Options for Tightening Policy: A focus on the medium term with an eye to the long term

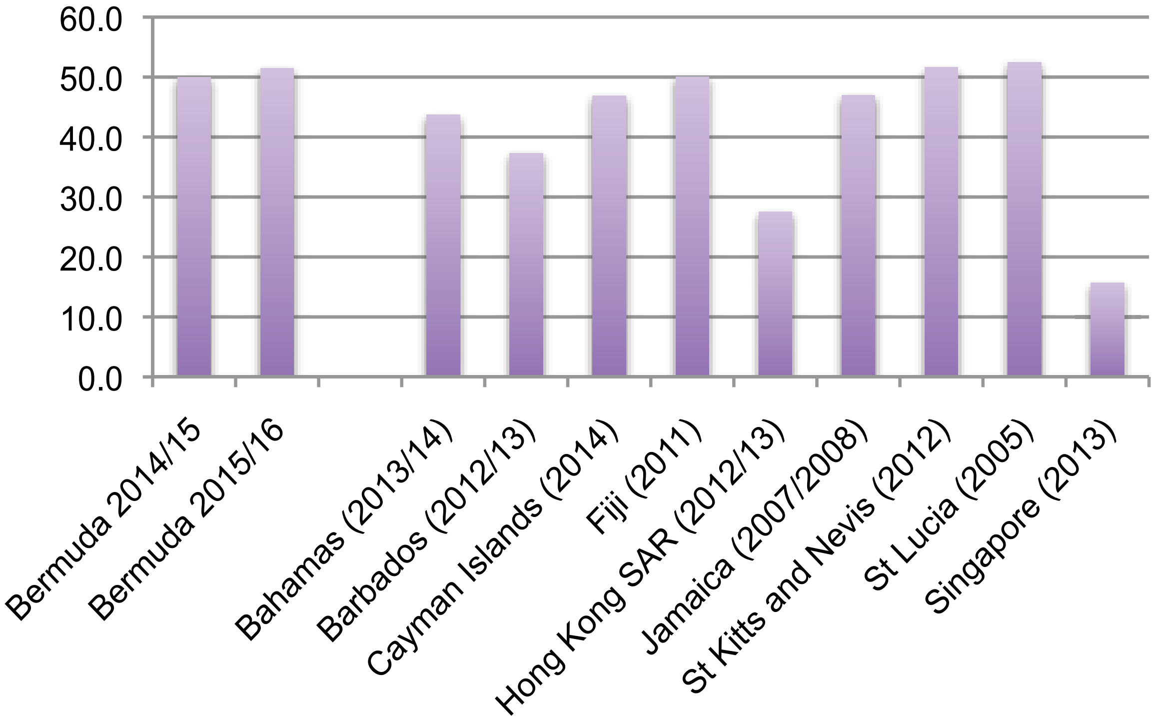
44. The previous sections underscore the *immediate* challenge of tightening Bermuda's budget stance over the medium term to substantially reduce the ratios of government debt and debt service to revenues to more fiscally manageable proportions. They also note potential liabilities from public guarantees, and financial challenges that will only emerge more slowly, over the next several decades. An ageing population will result in extra pressures on spending. And recent actuarial assessments quantify the implicit debts associated with the Government's unfunded net liabilities in the pension and health spheres. This section discusses what kinds of revenue and expenditure measures could be introduced to realize the adjustment contemplated in the third scenario while still promoting growth. Getting government debt levels down will free up budgetary resources to address some of these and other spending challenges. With interest outlays now absorbing 13% of current expenditures (excluding the sinking fund contribution), a reduction in debt to a level equivalent to 80% of revenues could free 7-8 % of present current expenditure for other purposes. But there will also need to be changes to key features and parameters of government pension and insurance programs to reduce, over time, the extent of their unfunded liabilities. These issues are touched on briefly in this section but more fully in Annexes B and C.

Containing expenditure in the short to medium term

45. Paragraphs 15 – 23 above describe some of the successes and difficulties encountered so far in implementing measures to reduce spending. A review of the budget highlights the difficulties faced by the authorities in realizing the further significant savings on the expenditure side that will be necessary to deliver the Budget plans already in place. Excluding the cost of interest and sinking fund contributions (debt repayment), and outlays on education, medical care costs, and Financial Assistance, only roughly half of the current expenditure budget remains, and these excluded items are either nondiscretionary (debt service) or services that will be subject to pressures for expansion (medical care and Financial Assistance). This implies that the planned further cutbacks in the current expenditure budget will have to be found by achieving greater efficiency in the provision of services and by a reduction in the government work force. With almost 85% of the Budget presently spent on wages and salaries, grants and contributions, and debt, it is clear that if further savings are to be made there would need to be a significant rationalization of public service provision and this will require difficult policy decisions. The potential for some further restructuring and reform is suggested by a comparison of the Government's outlays on wages and salaries compared with other small open economies (see Chart 3[8]). The Government's proposed current expenditure budget for 2015/16, with savings of $42 million from 2014/15, thus appears ambitious in the right direction.

8 These statistics are based on heavily aggregative data from budget statistics. Countries may differ as to whether wages and salaries include overhead or social contributions on behalf of their employees. Countries also differ on the extent to which current expenditures include limited or extensive social insurance outlays.

Chart 3: Selected Small Island Economies: Wages and Salaries as percent of Noninterest Current Expenditure



46. Given these difficulties, in most cases we endorse the specific measures undertaken by the Government in seeking to achieve budgetary savings in 2015/2016. But five points require some mention. First, we note how difficult it is proving to be to realize these envisaged budgetary savings; some ministries have already indicated higher than budgeted spending and this is forcing the Government to impose cutbacks or freezes on certain types of spending in the remainder of the budget year. Such measures will be difficult to carry forward to future years and may adversely affect efficiency or prove costly in terms of future growth. Second, as noted earlier, achieving the budget deficit target by not making payments of required matching pension contributions for government employees only shifts the implied deficit to the future in the form of a higher unfunded liability for the PSSF. This is not an approach we would recommend. Third, and analogously, capping certain subsidies (e.g., the aged subsidy) also represents a blunt approach to addressing issues that may require more complex structural solutions. Fourth, across-the-board cutbacks, or hiring freezes, while looking simple, are rarely an approach that improves efficiency, effectively avoiding the hard challenge of discriminating between services with very different marginal productivities or value. Finally, attempts to limit Financial Assistance have proved difficult to sustain and would impose hardship on those in society least able to bear the burden of a loss of support. As discussed below, with an ageing population and significant inequality in the distribution of income and assets, the Financial Assistance program may need to be called upon further as a social safety net.

47. In-year adjustments to spending plans are inevitable, but in future rather than seeking to impose temporary short-term offsetting measures it would be preferable to budget on the basis of a contingency reserve to take account of additional spending pressures (or slippage in making spending reductions) rather than having to introduce ad hoc measures in the course of the financial year. The Government already has a small contingency fund (of $1 million) but this is not adequate for a budget of $900 million, and its use is limited to meeting emergencies; as currently designed it would not appear to be available for meeting overspends on programmes like Financial Assistance. We recommend that future budgets should provide for a contingency reserve of approximately 1% of (non-interest) expenditure.[9]

48. Looking forward to 2016/17 and 2017/18, the challenge to realizing yet more stringent budget targets will be even more difficult and will require structural reforms in the way in which services are delivered and institutions are structured. Here the SAGE Commission Report offered many provocative and challenging ideas on how consolidation of departments, cutbacks in the size of the legislature, privatization, and outsourcing could be achieved in many of Bermuda's government departments and legislature. They noted in particular significant weaknesses and inefficiencies in service delivery in the transport, waste disposal and public works sectors. The Government appears to have taken the important first step in its attempts at improving accountability, strengthening budgetary planning, conducting performance evaluations and moving towards the adoption of a Ministerial Code of Conduct. We also understand that the Government is seeking to prioritize the SAGE Commission recommendations, both in terms of timing and effects on the budget and efficiency. We are not in a position to judge the relative merits of alternative spending areas but wish to underscore the critical importance of efforts at prioritization of government budgetary allocations and addressing inefficiencies. It will be important to demonstrate with *visible* actions that alongside increases in taxes the Government is serious in its endeavor to improve efficiency and reduce waste.

49. This should entail at least four critical steps.

- First, identifying which areas of current budgetary spending are the sources of greatest inefficiency and budgetary costs and considering where there is the greatest scope for savings.

- Second, an assessment of whether there are areas of government business where some *increased* employment or rationalization of current procedures or organizational structure might pay off in higher economic growth or government revenues. For example, a reorganization of the administration of tax (and health insurance premium) collection and customs duty and/or an increase in its size might result in increased compliance and higher revenue productivity from existing taxes and duties. Similarly, increased resources for tourism marketing and development could have a significant pay off in terms of growth and employment – and ultimately government revenues.

- Third, consideration of whether there are areas where privatization of government assets or outsourcing in the delivery of services could deliver improvements in efficiency.

- Fourth, assessing areas where government efforts to improve equity through subsidies are resulting in an excessive leakage of benefits to the non-poor.

9 The reserve could be based on an expanded contingency fund with revised rules of access. It would be included in the annual Budget on the same basis as Departmental spending. That is, it would be included in aggregate spending totals and in the calculation of the surplus target, but the money would not necessarily need to be formally appropriated by Parliament until and unless it was disbursed. Disbursal would be subject to approval by the Ministry of Finance according to an agreed set of rules, to ensure that it operated only in the case of genuine contingencies.

Measures to contain spending over the medium to long term

50. Finally, in the longer term, actions are clearly needed to gradually strengthen the finances of the government's various pension and health insurance programs, both on and off-budget in order to address the scale of unfunded liabilities (see Box 3). It is here where some of the SAGE report's recommendations would ultimately yield the most important budgetary savings, but with the impact felt primarily long in the future – by substantially reducing the magnitude of actuarially unfunded liabilities in pensions and health insurance schemes for public employees and, to a lesser extent, in the CPF. Such savings can matter, reducing the likelihood that the Consolidated Fund will be called upon to compensate if the CPF's assets are exhausted, or in limiting the extent of excessive upward adjustments in the contributions that would be required of future employees. Some of the SAGE Commission's recommendations in these spheres may also yield current budgetary savings through higher premiums, pension contributions or copayments, reduced benefit provision, gradual curtailment of eligibility for the GEHI to new retirees and the spouses of government employees, and reduced subsidies and transfers. While nontrivial, the short-term budgetary savings from these latter proposals are more limited and less significant in terms of the immediate objective of explicit public debt reduction (see our discussion in Annexes B and C).

51. In addition to these unfunded liabilities the government will also face increased budgetary pressures from rising health care costs. An ageing population will create further challenges in terms of

Box 3

Estimates of Unfunded Liabilities in the Pensions and Health Insurance Sphere

As of the last Financial Statement of the Bermuda Government's Consolidated Fund for end-March 2014 (reflecting the most recent actuarial valuation of October 2014), the Public Service Superannuation Fund (PSSF) for public sector employees had an unfunded liability of $800 million, which, taking account of assets in the Fund, implied a funding ratio of 41% of total actuarial liabilities. This low ratio already took account of the decision to suspend any cost-of-living adjustments on PSSF pensions. Two other pension funds also exhibit significant unfunded liabilities: the Ministers and Members of the Legislature Pension Fund (MMLPF), a much smaller fund, revealed a funding ratio of 53.9%, with unfunded liabilities of $10.7 million; and the Bermuda Contributory Pension Fund (CPF), a national basic defined contribution pension scheme, that was estimated, as of the last actuarial review of August 2011, to have unfunded liabilities that could range from B$500 million to as much as $3.1 billion, depending on the assumptions made as to benefit rate increases and amounts of further contributions beyond 2011. An alternative indicator of the CPF's position is that the Fund will be exhausted by 2047 if no changes are made to the contribution and benefit structure. The actuarial estimate of the accrued liability of the Government Employees Health Insurance Fund (GEHI) (an unfunded plan) as of end-March 2014 was $331 million. In total, such accrued unfunded liabilities amount to a minimum of $1.64 billion (using the most conservative estimate for the CPF), and substantially more - closer to $4 billion - using the most adverse assumptions for the CPF.

financing and providing high quality medical care and long-term care for the very elderly. This will only become more daunting as new medical technologies expand what is possible in terms of treatment and care. In short there needs to be significant reform of the current health care financing arrangements. Without such an overhaul government health subsidies could increase, possibly by as much as 3% of GDP in the long term. Even with an overhaul of current arrangements some extra spending is likely to be needed.

52. One other medium-term expenditure issue many have raised with us is the airport project. Although strictly speaking as a public-private partnership project it would not involve public spending, the loss of airport revenues net of operating costs over the medium and longer term is probably best regarded as a form of expenditure commitment. In any event it is a fiscal cost that, given the fiscal situation, would need to be offset by other fiscal measures, in practice by some additional increase in taxes. So decisions should take into account not just whether the project has value for money (including in the sense of delivering an acceptable economic return) but whether the future fiscal costs involved represent the best possible use of limited budget resources.

Increasing the revenue share

53. Our own judgment is that it is likely to prove difficult to achieve additional spending reductions beyond those already budgeted in the MTEF in the short term. As noted above, if implemented, these will result in a further reduction in current spending as a proportion of GDP by 2%. In the longer term spending as a share of GDP may well need to be increased. As discussed in paragraph 42 above this suggests that to achieve an additional fiscal adjustment of 2½% of GDP it would be prudent to target an increase in revenues equivalent to 3% of GDP. Bermuda's tax ratio in 2014/15 was about 15.6% of GDP, with the share projected to rise to 16.1% in the current budget year. The two principal sources of revenue are customs duties and a payroll tax levied principally on employers (independent of social insurance contributions), with lesser revenues derived, *inter alia*, from a land tax and a range of license fees and other charges. In a recent listing of countries by tax share (CIA World Fact book, 2015), Bermuda is ranked at 181st (of 216) among countries in the world (see Chart 4).

54. Although there may be questions as to whether the tax share for some territories, including Bermuda, should be somewhat higher for comparative purposes if social insurance contributions were included,[10] we believe that a territory with Bermuda's high per capita income could accommodate a higher share without being out of line with the shares in other small island economies of similar size and structure. Increasing the revenue share by 3% of GDP would bring the share up to 19% of GDP. Even if the share needed to be increased further in the long term to accommodate expenditure pressures, a revenue share of say 20% would still leave Bermuda at the lower end of the scale measured against comparator jurisdictions.

55. The Government is currently considering a detailed report by the IMF's Caribbean Technical Assistance Center (CARTAC) on ways to raise additional revenues and on possible reforms to the structure of taxes. We therefore confine ourselves to some general observations and suggestions.

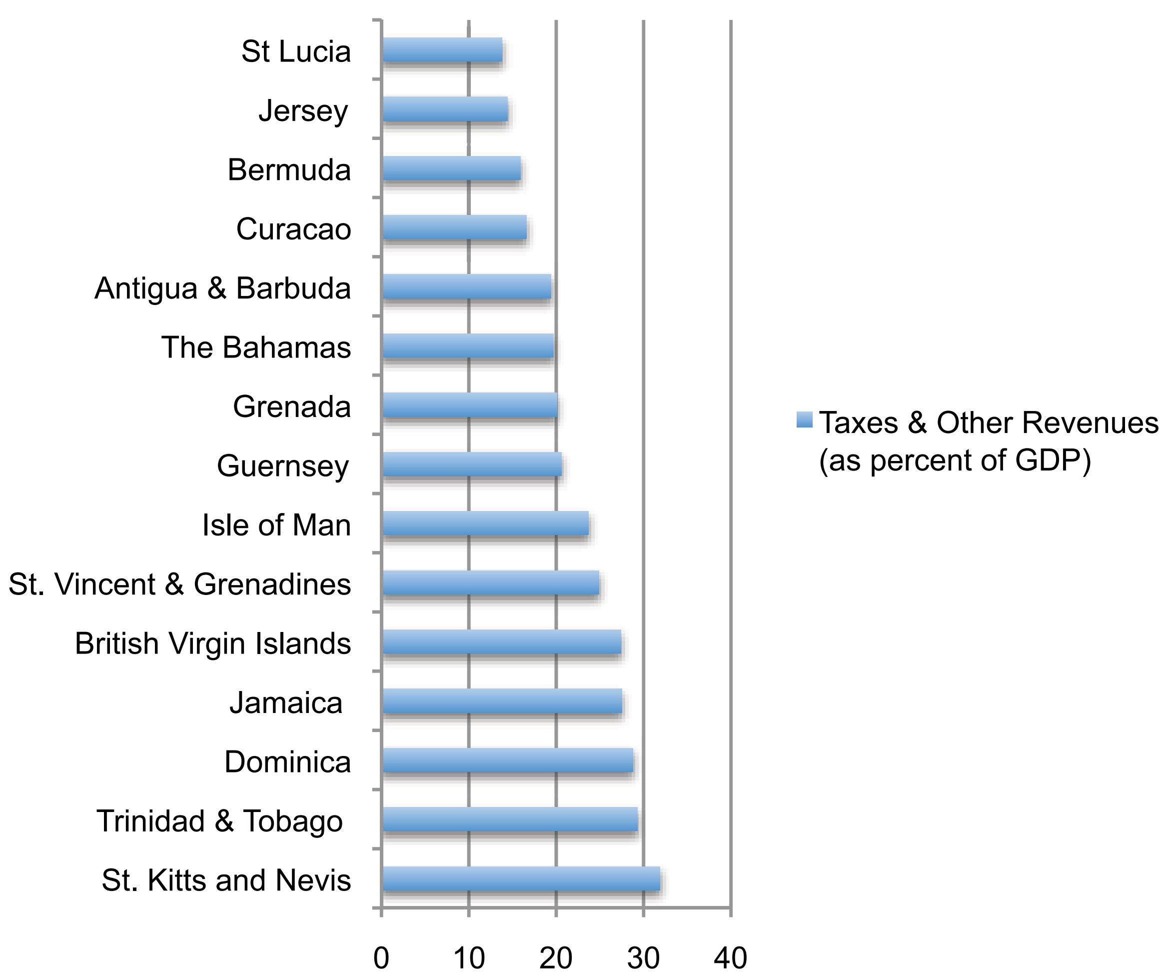
56. There are some obvious considerations that limit the choices open to the Government and that should influence policy. First, as far as possible any measures adopted should avoid any adverse impact on Bermuda's principal industries. Second, priority should be given to measures that promote allocative efficiency – for example by removing current distortions in the tax system – or other desirable goals such as greater equity, better health or a better environment.

10 This tax share does not include contributions made to the CPF, which amount to about 2% of GDP, the two principal government pension funds and the GEHI. This is one of the reasons why these comparative figures differ from those illustrated in the 2015 Budget statement. Such contributions go directly to independent extra budgetary funds, which incur outlays that are also not included in the Government's budget. Tax share comparisons across countries need to be regarded judiciously, since countries often differ in whether they include social contributions or not in their measure of the Government.

Third, measures chosen should be capable of being implemented by the territory's limited administrative capacity for tax collection and enforcement. In this context it would clearly be important to leave adequate time for implementation of any significant reform to the structure of taxes. So one approach to a phased increase in revenues would be to move first to adjust existing taxes and duties while at the same time starting work on reforms to be implemented in two or three years' time.

57. One immediate source of extra revenue would be to phase out over time some existing tax concessions in the energy and hospitality and retail sectors. Two concessions in particular stand out as costly in revenues forgone and where the rationale for the concessions could be reconsidered. The current tax concessions for fuel amounts to almost $30 million annually.

Chart 4: Revenues as a share of GDP, selected territories



While removal of this concession might imply some increase in electricity rates, its impact should be softened by the current low fuel price, especially if complemented by the current regulatory policy initiative in the energy sector (which could open the way to lower cost competition). In the hospitality and retail sectors, current payroll tax and customs duty concessions cost the budget around $40 million annually. While we recognize that such concessions were given to encourage investment, the time may have come to phase them out, particularly as other policies to promote tourism begin to pay off.

58. A second area for possible reform is the taxation of income from employment. Although Bermuda does not have an income tax, its existing payroll tax has a well-developed collection system, reaches a significant share of total income and entails a tax that can be related to an individual's income. The combination of a small increase in the payroll tax rate, elimination of the cap on earnings subject to the tax, and a narrowing of exemptions to the tax could contribute in the short term to the target for additional revenue. Additionally, some non wage benefits, such as health insurance payments, could be included in the base for calculation of the tax and actions could be taken to address perceived inequities in the way that incomes of self-employed are taxed. Another option to consider would be a separate tax on labor income, possibly on a progressive basis, as a means of improving the overall equity of Bermuda's tax system.[11]

59. A third area is taxes on land and property. These have two advantages: first, they are among the least distortive of taxes, and in particular (unlike taxes on income) are unlikely to reduce economic activity. Second, their burden is felt by those who own property and are therefore likely to be relatively better off. Tax rates could be increased in the short term, while considering longer-term reforms to improve equity and efficiency.

60. Other areas where the Government could move quickly to raise revenues in the short term include:

- Raising or imposing customs and excise duties on products that are harmful to health or the environment, including tobacco, alcoholic beverages and petroleum products.[12] Petroleum taxes are currently low by European standards and given recent declines in the oil price, raising them might simply return retail prices to where they were a year or so ago. And extra taxes on petroleum products (principally diesel and fuel) would not only mobilize revenue but also serve to reduce vehicle use, encourage the purchase of more fuel-efficient motor vehicles, and limit vehicle emissions.
- Higher registration fees for international companies.
- Addressing the significant noncompliance by many taxpayers, by a reorganization of the tax administration apparatus, some increase in its staffing, and outsourcing of debt collection.

Given the scale of revenue increases needed there may be a case for spreading the burden of increases over a range of different taxes.

61. Turning to possible longer-term reforms in the tax structure, we note that consumption taxes are an obvious source of revenue mobilization that would not adversely affect Bermuda's principal industries while providing a robust source of revenues for the future. In most countries, such a tax would take the form of a general retail sales tax or a Value Added Tax (VAT). Indeed, a VAT has been introduced in most countries of the world, including many small island economies, and is recognized as a potent revenue-raising measure. Among developed countries with per capita incomes as in Bermuda, the general norm is for each percentage rate of the VAT rate to yield about 0.5% of GDP in revenue. Such a tax could thus generate revenues of 2½% of GDP with a tax rate of around 5%. However, in Bermuda's case, given that it imports most of its consumption goods, an alternative approach to raising additional revenues from consumption would be through a broad-based increase in customs duty rates on consumption goods, supplemented over the medium term with the introduction of a new tax on services, which appear presently under-taxed (with exemptions provided for exports and for government, education, and health services). Recognizing that such increases in taxes on consumption would affect lower income

11 Converting the payroll tax into a form of personal income tax.
12 Consideration could also be given to treating soft drinks as an excisable commodity, given their heavy sugar content and the challenge of containing the current epidemic of obesity and diabetes in Bermuda.

groups in Bermuda, some of the additional revenues could be used to benefit those segments of the society most adversely affected.[13]

62. Finally, in our discussions we have noted, perhaps surprisingly, some incipient interest in introducing some form of corporation tax on the island over the medium term (particularly were it to be levied in a context of strong government actions to address perceived inefficiencies in government administration and service delivery). Some see it as a way to counter perceptions of Bermuda as a tax haven. Taxes on company profits in Bermuda, however, would be subject to considerable volatility and depending on such receipts for annual budgets could lead to similar volatility in budgetary financing. Both a corporate profits tax and an income tax would also require considerable time to put in place the administrative mechanisms for compliance and enforcement. At most a corporate profits tax could possibly provide a modest supplement to other revenues. But it could not realistically be seen as a replacement for any of the more reliable key revenue sources.

VII. Conclusions

63. Bermuda's economy faces a number of risks and uncertainties, short term and longer term. The current level of government debt – taken together with very large potential liabilities from government guarantees and underfunded public pension and health insurance schemes – risks turning the possible impact of any one of these into a serious setback for the island's economy.

64. Reducing debt and debt service costs is therefore a priority. Meeting the aim of a balanced budget in 2018/19 is appropriate, as is the aim of meeting the 80% and 10% targets set for the ratios of debt and debt service to revenue. We suggest dropping the debt/GDP target, but achieving the debt/revenue target would deliver a debt/GDP ratio of around 15%.

65. Economic growth prospects over the next few years look better than for some years, providing a window of opportunity to reduce debt to a safer level. Maintaining growth longer term requires continued competitiveness of two key industries, tourism and financial services/insurance, and finding ways to address serious demographic challenges.

66. Progress on fiscal consolidation so far has been cautious and incremental. A more aggressive approach will be needed to meet balanced budget and debt targets. On stylized assumptions about growth and inflation, an additional fiscal tightening equivalent to around 2½% GDP will be needed to meet the debt to revenue target within 5 years of achieving budget balance in 2018/19. This we believe would be a credible timescale to set, and should be reassuring to the domestic public as well as investors and capital markets. Hopefully it could gain at least a measure of broad support as a suitable fiscal aim for the island: this will also be important for credibility and external confidence. Debt reduction could usefully be supplemented by action to limit further potential government exposures arising from the provision of guarantees.

67. The Government has already programmed in substantial spending reductions in its medium-term economic framework equivalent to around 2% GDP by 2017/18. Achieving these will not be easy and will require making a start on fundamental restructuring of government services, particularly as some of the short-term measures to contain spending taken to date will not be sustainable in future years. There needs to be a determined and visible effort to reduce waste, strengthen efficiency and direct available resources to the highest priority areas. With Bermuda facing a serious demographic challenge, actions are also needed to address rising health costs and the underfunding of pension schemes that will cause increasing problems over the long term.

13 For example, this might be achieved by expansion of the Financial Assistance program, or additional help for health outlays of low income elderly.

These latter actions will involve early steps to adjust some of the terms and features of government pension and health insurance schemes, actions that will reduce the projected deficits of these schemes. We make more detailed suggestions in Annexes B and C, many of which are already under consideration. While much can be achieved without recourse to more public spending it seems unlikely that in the long run an increase in public spending can be avoided altogether. Debt reduction will open up much needed fiscal space by cutting debt service costs (now approaching 20% of the national budget) to help deal with such pressures, although possibly not enough.

68. So to meet the debt targets within 5 years of 2018/19, delivering the savings already planned and resisting new expenditure pressures will be a hard enough task; all or nearly all of the additional fiscal effort needed after 2016/17 will have to come from revenue increases. We therefore suggest that to allow for possible slippages in expenditures or revenues it would be prudent to target an increase in revenues equivalent to around 3% of GDP, implemented over the course of the three years starting 2016/17. This would raise the revenue to GDP ratio for Bermuda from 16% to 19%, still a low level compared to other similar jurisdictions. Given the medium and longer-term spending pressures, the ratio might have to be raised a little higher in the medium term, but even if it rose to 20% it would remain below most comparator jurisdictions.

69. The Government is currently considering advice from the recent IMF CARTAC mission on options for raising additional revenue. It will be important to find approaches that so far as possible avoid damage to the island's most important industries; avoid placing extra burdens on the least well off; contribute to goals such as allocative efficiency, better health or a better environment; and that can be handled by the island's limited tax administration capacity. Structural changes such as the introduction of a broader consumption tax or a services tax to complement customs duties on imported consumer goods would take several years to implement, probably with a prior period of consultation. We therefore suggest a phased approach with immediate consideration given to steps that can be implemented in 2016/17. These might include phasing out some customs and duty concessions, particularly those on some fuel imports and payroll tax concessions granted to the retail and hospitality sectors; adjustments to customs and excise duties on petroleum products, tobacco, alcohol and possibly soft drinks; and gradual reform of the payroll tax system.

70. Taken together with the already planned expenditure reductions this would constitute a balanced set of measures to address Bermuda's fiscal and debt issues, and such balance could help build the needed measure of broad support for the strategy.

71. Once decisions have been made, it will be important to monitor progress carefully. While we recommend setting out a clear target timetable for meeting the territory's debt targets, progress is unlikely to be smooth. Growth and/or inflation could turn out to be faster or slower than assumed in our illustrative scenarios, making progress easier or harder to achieve. So the strategy and speed of consolidation should be reassessed every year with policy adjustments made as needed.

72. We look forward to making our next assessment in a year's time.

Annex A

The Panel had meetings with the following institutions/individuals during the course of its discussions in Hamilton (November 23-27, 2015)

Office of the Accountant General

Association of Bermuda Insurers and Reinsurers

Bermuda Bankers Association

Bermuda Health Council

Bermuda Hospitals Board

Bermuda Monetary Authority

Bermuda Public Services Union

Bermuda Industrial Union

Bermuda Tourism Authority

David Burt, MP, Shadow Minister of Finance

Nathan Kowalski: Economic Commentator

Ministry of Finance

Pensions Commission

Statistics Department

Craig Simmons: Lecturer in Economics, Bermuda College

Annex B

Attending to the risks to the budget of future pension liabilities and the costs of the Government Employees Health Insurance Fund (GEHI)

The Government's pension funds for its employees and its GEHI are responsible for unfunded liabilities that stretch out over many (75) years and whose estimates are subject to uncertainty—depending on assumptions as to the appropriate discount rate, rate of return on financial assets, mortality experience, and other demographic variables. Moreover, the Financial Statement of the Bermuda Government's Consolidated Fund clearly indicates that at least for the CPF, there is "no legislative provision for the [Consolidated] Fund to provide for any shortfall if, at any time, the CPF has insufficient funds to meet its current legislated obligations." But even excluding the CPF—despite the obvious political pressure that would be placed on the Government to meet these obligations—the PSSF, GEHI, and MMLPF together are currently judged to have unfunded liabilities of $1.14 billion.

These relatively low funding ratios should be a source of concern. Experience in comparable situations—state pension plans in the United States as well as in Puerto Rico—suggest the vulnerabilities that can accrue to a state even when there is maximum constitutional flexibility to make adjustments in benefit formulae. Recent discussions in actuarial fora, the US Government Accountability Office, and the Government Accounting Standards Board lean towards recommendations on the importance of two criteria: having an adequate funding ratio – many suggest as high as 80% – and ensuring the sustainability of a pension plan. Both the actuarial consultant, Morneau-Shepell (MS) and the SAGE Commission have offered useful recommendations as to the actions that could be taken to strengthen the financial position of these funds. In this regard, the Bermuda authorities are to be commended for ensuring that actuarial assessments of the PSSF, MMLPF, and CPF are regularly undertaken and transparently made available. The Government has taken initial steps to address the unsustainability of these unfunded liabilities by its decision to suspend, as of 3/31/2014, the COLA for both current and future pensioners for both the PSSF and MMLPF.

PSSF: It is now important to begin to implement the recommendations of the SAGE Commission and, more recently, of the Pension and Benefits Working Group, on the changes that should be made to the PSSF in order to move it to a more sustainable funding position. These changes include: the gradual increase in the retirement age (differentiated as between most employees and police, fire, and prison workers) with the gradual adoption over 10 years of "early retirement penalty factors"; the shift in the pension salary calculation to a final 5-years' average salary; attaching a cost to the spouse and dependent's benefit (with the benefit only relevant for existing spouses at retirement); a slightly reduced pension accrual rate, a reduced lump-sum commutation factor; and the already adopted suspension of the COLA adjustment. We would emphasize the importance of their recommendation that the Government not suspend its matching contributions to the PSSF. In terms of governance, public pension plans should be held to the same standards that are required of private plans, and with independent oversight of their management.

MMLPF: We support the views of the SAGE Commission that the MMLPF's provisions are excessively generous compared to those of the PSSF, that the scheme is unsustainable and that the actuarial cost of a participant's benefit accrual is significantly underfunded. However the scheme does not pose many risks to the Government's finances and we understand its provisions can be refined to meet the SAGE Commission concerns.

We recognize that these adjustments to the PSSF and MMLPF schemes may not be well received by public sector employees, no matter how gradually many of the reforms are implemented (particularly with regard to the age of retirement, early retirement factors, and the adjustment of the salary base). But the reforms that have been suggested are very much in line with best practice reforms in the private and public sectors of other developed countries with defined benefit pension plans. Without them the existing system will not be sustainable, raising the prospect that either much more extreme adjustments in benefits would be necessary in the future or that substantial private or public contribution adjustments would be required, burdening workers or taxpayers. As in other countries with ageing populations and high incomes, the challenge of fiscal sustainability and achieving fairness to the younger generations must be recognized. Most countries are now confronting the fact that the social insurance promises made to the elderly when life expectancy was much less, are no longer affordable with life spans reaching into the 80s and 90s. While these reforms are painful, they are aimed primarily at middle-income groups within the society that have the capacity to adjust.

Bermuda Contributory Pension Fund: The importance of financial sustainability of the CPF is particularly critical, since there is an explicit legislative prohibition against its reliance on the Government's Consolidated Fund, and given that the CPF is the pension of last resort for those Bermudian elderly that have not been part of the more recent National Pension Scheme. The SAGE Commission report provides important evidence on the critical challenges facing the CPF. These include the more severe ageing of Bermuda's population, the declining size of the working age population that will be the principal contributors to the CPF, and the increasing life span of pension recipients. While over time, the National Pension Scheme (NPS) and the PSSF will become the principal sources of retirement income for many Bermudian elderly, for those not contributing to the NPS, the CPF will be a vital safety net. It is not a particularly generous source of income, particularly after subtracting the cost of health insurance premiums and copayments for medical care (even taking account of the extent of the subsidies provided for the HIP and Future Care premiums for the elderly). The Government's decision to increase the CPF contributions by 2.5% more than any benefit increase was therefore an important first step in reducing the degree of underfunding of the CPF scheme.

If investment returns on the CPF's assets exceed the assumption of a return of 2.5% above benefit adjustments, these contribution increases could be adjusted downward.[14] SAGE also emphasizes the need to gradually increase, over a 15-year period, the retirement age for the scheme to 68 years, with a possible need to subsequently further increase the age to 70 in order to limit the burden on – and help to offset the decline in – the future working age population. While we would support the latter proposal, we strongly believe that such a change should be accompanied either by some means testing or by an approach that yields regressivity in the benefits (viz., higher CPF benefits for lower-income recipients). This would both increase the financial sustainability of the scheme and perhaps even more important, provide for greater equity. Recent research in the United States indicates that lower-income groups have a considerably lower life span after retirement, so that their period of benefit receipts is on average less than for higher-income recipients.

Government Employees Health Insurance Fund (GEHI): Though it is difficult to fully gauge the actual annual cost to the Government from the operations of the GEHI,[15] it appears that the GEHI has experienced losses over the last several years. Undeniable also is the large scale of the unfunded liability, now set at B$330 million (excluding experience losses) and the combination of ageing and health cost pressures that contribute to these estimates. The projected increase over the two years of 2015/16 and 2016/17 in GEHI premiums of 38% also suggests that current premium rates have proven insufficient to cover costs. The SAGE Commission's review of alternative approaches to post-retirement health insurance benefits (in the private sectors of Bermuda and in Canada) led them to recommend, inter alia, the cessation of this benefit for new retirees (with a 7-year declining grandfathering benefit),

14 The SAGE Commission notes that such increases would imply that "for a person earning $50,000, the starting cost for the Contributory Pension Fund is 3.3% of their earnings and in 20 years will become 6.0% of their earnings if there are no other changes."

15 The Government's annual budget estimates only include its matching contribution to employee contributions to the GEHI. The full cost of benefit payments in excess of premium contributions is reflected in the audited Financial Statement of the Bermuda Government's Consolidated Fund as an additional liability.

a flat-benefit payment to existing retirees (implying an increasing cost of premiums to such retirees over time) and curtailment of government-financed premiums to spouses of new retirees. The effect of such recommendations, if they had been implemented in 2014, would have been a $169.5 million reduction in the unfunded liability of the GEHI. Given the gradual nature of the benefit reduction, the GEHI will continue to be a source of budgetary pressure over the medium term, with reforms not likely to be a source of immediate budgetary savings.

Such policy actions would imply that retired government employees would increasingly seek health insurance coverage, either from the Health Insurance Plan (HIP) or the Future Care program. This will thrust more focus on the cost to the Government of these programs, given the local premium subsidies provided for the elderly.[16]

16 Local claims subsidies are 70% for those between ages 65-75, and 80% for those over age 75.

Annex C

The fiscal challenges posed by the ageing of the population and the rising cost of medical care

Compared to countries in the OECD, Bermuda's health care system is exceeded only by the United States in terms of its costliness, reaching 12.4% of GDP and with per capita costs in 2014 reaching $11,188 (more than twice that of most other small island economies and double the OECD average when measured in purchasing power parity terms). Yet Bermuda's average life expectancy is lower than a majority of OECD countries. Health care financing and delivery in Bermuda involves a mixed role for the public and private sectors. Most services are provided either by private sector practitioners or by the two hospitals managed by the Bermuda Hospitals Board (BHB). More than two thirds of total financing derives from the private sector, including out-of-pocket outlays and insurance through employers (including the GEHI), as well as two basic health insurance schemes of the Government, one for the elderly (Future Care) and a more limited basic scheme (the HIP). Government subsidies and grants finance about 20% of outlays, particularly in relation to the young, indigent and elderly, in part through the Standard Health Benefit (SHB), through Future Care and through grants to private nonprofit organizations for health-related purposes (principally through the BHB). The Government also finances health promotion and prevention efforts, as well as primary care particularly directed at children and mothers.

Several concerns clearly are on the horizon:

- The **increased ageing of the population,** the shrinking of the working-age population, the rising cost of health care and the high prevalence of such chronic diseases as diabetes will put further pressure on several key variables in the health sector: government expenditures, principally in relation to patient subsidies but also with respect to subsidies of the health insurance costs of the elderly and the young; and premium rates (both as costs increase and as the size of the weighted (by age) premium-paying group) declines. Specifically, by 2021, the population over age 65, where the premium subsidy for HIP and Future Care is roughly 75%, will rise by about 20% and it will rise by a further 20% by 2026, with further increases in the following decade. This will only be partly offset by a smaller decline in the younger population, where the implicit subsidy is significantly lower. These results emerge from a December 2012 MS report to the Bermuda Health Council on *Health Financing Structure Options for Bermuda* (unpublished).

  In the most conservative of its projections, MS assessed that these demographic trends would increase the Government's current subsidies for medical care, in constant 2013 dollars, from $164 million to $272 million in 2033 and $307 million in 2043. Such increases would not include the higher employment costs to government through its employer contributions to the GEHI; the pressures for further subsidies to the BHB to cover the costs of indigent and uninsured citizens; and the rising cost of long-term chronic care that would be borne by Future Care. Such cost increases would be substantially larger were there to be a change in unit prices for medical care and per capita age-specific utilization rates: including these, the cost of the medical care system (and implicitly government subsidies) could double by 2043.

- **Limits on the present coverage of medical insurance:** There will be a need for better insurance coverage of outpatient care, especially as the burden of illness increasingly is in the form of chronic and noncommunicable diseases. Such coverage might prevent higher future hospitalization costs and foster the use of cost-effective outpatient primary health care services.

- **Holes in the present insurance coverage and administration:** The Bermuda Health Council's *Health Disparities Report 2013* suggests that 8% of the population is uninsured, with the ratio significantly higher, at 25%, among low-income groups. Another challenge is the non-compliance of some employers in forwarding employee HIP premiums to the Government adding to the net cost of meeting claims.

- **The need to contain cost increases caused by a number of predictable developments in the health sector,** including the implications of a rising burden of chronic long-term care for the very elderly in the next 15-20 years. Presently, the measures pursued by Government in recent years to contain health care costs and subsidies, specifically, the shift of the Mutual Reinsurance Fund (MRF) premium to be included by health insurance providers, the decline in the extent of Future Care subsidies, the introduction of preventive approaches to chronic disease, the curtailment of portability subsidies for overseas treatment, the use of dedicated overseas private practitioner networks, and new approaches to long-term care – reflect the high importance attached by the Government to managing outlays in this sector. Such vigilance will be a continuing necessity but containing costs will become more difficult. One approach to consider that could contribute to restraining demand factors that contribute to health cost pressures is to end the current exclusion of health insurance benefits in the definition of wages subject to payroll taxation. In the United States, health economists have argued that a similar exclusion of such benefits from the income tax incentivizes companies to provide compensation in the form of health insurance benefits rather than taxable wages and salaries.

- **Risks to the affordability of medical insurance:** low-income groups in Bermuda may find it increasingly difficult to afford premiums even for HIP, let alone Future Care. While conditions for access to Financial Assistance (which pays the Future Care premiums of its recipients) are quite stringent, there may nevertheless be an increase in demand for this support.

- **Risks that the current financing system will not prove sustainable,** with the possibility that some of the still present private insurance providers pull out from the market.

  The MS report provided a very useful discussion of the weaknesses of the current health care financing system and discussed the pros and cons of alternative reform options. In many developed countries, the adoption of a unified financing system has yielded important benefits in terms of efficiency and financial sustainability. Even in the absence of reform of the health financing system, the following policy issues will still require attention:

- **Targeting of health care subsidies:** the current system of subsidizing the elderly only focuses on the age of the individual – over age 65 and 75, with premium subsidies of 70% and 80% respectively. Consideration of some form of means testing may not avoid the challenge of rising subsidies, but at least better target them to those least able to afford care.

- **Introduction of alternative approaches to payment for services:** most industrial countries have introduced a range of innovations to address the potential moral hazard of insurance and fee-for-service payment systems in the provision and use of services (e.g., capitation systems for outpatient care, diagnostic related groups (DRG) as a basis for hospital charges, and better monitoring of charging practices of clinicians).

We are impressed by the efforts of the Bermuda Health Council to understand and grapple with the complex challenges that will be increasingly faced by Bermuda in trying to contain health costs, steer the population toward better health practices, achieve equity among its citizens, and navigate a course that provides affordable but high quality health care that meets the demands of its citizenry in a world of rapidly changing options and possibilities. The challenge now for the Government is to act ahead of a cost curve that will see increasing pressures as a consequence of changes in the medical care and demographic environment. The options available are increasingly recognized and they will involve costs that will require gradual adjustment by all participants in the system. While these costs will be largely borne outside the Government's Budget, they nevertheless will influence the scope of what is affordable by employees, citizens and ultimately by the Government.

The Fiscal Responsibility Panel
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