BERMUDA

Fiscal Responsibility Panel

Jonathan Portes (Chair)
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2019 Annual Assessment

December 2019

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List of Acronyms

AML: Anti Money Laundering
BDA: Bermuda Business Development Agency
BELCO: Bermuda Electric Company
BEPS: Base Erosion and Profit Shifting
BHB: Bermuda Hospitals Board
BHP2020: Bermuda Health Plan 2020
BHeC: Bermuda Health Council
BMA: Bermuda Monetary Authority
BTA: Bermuda Tourism Authority
CARTAC: IMF's Caribbean Technical Assistance Center
CFATF: Caribbean Financial Action Task Force
COLA: Cost of Living Adjustment
CPF: Contributory Pension Fund
CPI: Consumer Price Index
CTF: Counter-terrorism Financing
GEHI: Government Employees Health Insurance Fund
GDP: Gross Domestic Product
GST: General Services Tax
HIP: Health Insurance Plan
IMF: International Monetary Fund
MMLPF: Ministers and Members of the Legislature Pension Fund
MRF: Mutual Reinsurance Fund
NRA: Normal retirement age
OECD: Organization for Economic Cooperation and Development
ORC: Office of the Registrar of Companies
OTC: Office of Tax Commissioner
PBWG: Pension and Benefits Working Group
SHB: Standard Health Benefit
SPR: Standard Premium Rate
TRC: Tax Reform Commission
UN: United Nations
UNESCO: United Nations Educational, Scientific and Cultural Organization

Executive Summary

This is the Panel's fifth annual report. As in previous years, we have had productive discussions with Ministers, officials and many others on the island and we are grateful for their advice, but all the judgements and recommendations are our own independent conclusions.

In our previous reports we highlighted Bermuda's vulnerability to external events as a small open economy competing in a global marketplace and noted specific risks that could lead to a severe financial crisis. External risks – not merely financial but also broader economic, geopolitical and environmental - have not yet materialised, but have increased over the last year, and are unlikely to diminish in the medium term. Given the fiscal position, and the limited progress of the Government in acting on our previous recommendations, we are concerned that Bermuda will have little fiscal or macroeconomic policy space to address any crystallisation of these risks.

Over the longer term, the key concern for policy action remains domestic: the island's shrinking workforce and ageing population will put ever-increasing pressure on both taxes and spending. The issue is not whether action is needed, or even what actions are needed – there is a high degree of consensus, as expressed in both our reports and those of other independent bodies and indeed within Government – but when and how. Immigration reform, tax reforms and tax increases, and changes to the structure of healthcare and pensions are all required.

On tax reform, we regard 2019 as a year of missed opportunity, not just because of the further delay in meeting the target for budget balance, but because of the absence of significant tax reform along the lines of that proposed by the Tax Reform Commission or this Panel, as well as the de facto easing of the government's fiscal targets facilitated by the suspension of contributions to the Sinking Fund. On top of this, the failure of the Caroline Bay development resulted in a significant increase in government debt.

On the positive side, the Government has made significant progress in setting out a clear agenda for the reform of the financing of the healthcare system, exploring measures to address the underfunding of the pension system, both public and private, and recognising the need for major reforms to the immigration system to boost the population of working age. While implementation of reform will inevitably take time and be politically contentious, we commend the Government's willingness to address these complex and difficult long-term issues.

These are not just issues for Government, but for Bermuda and Bermudians as a whole. We call on all those with a stake in Bermuda's future to engage constructively, recognising the need for change; the status quo on all these issues - health, pensions and immigration - is not sustainable and would lead over time to much higher taxes on working Bermudians and deteriorating public services.

We make a number of suggestions and recommendations in this report. The key issues that need to be addressed without delay are as follows:

- **Fiscal targets:** In view of the recent change with regard to the treatment of the Sinking Fund, the Government needs to set out, clearly and transparently, its fiscal strategy and associated targets for the next few years. In our view, the government should set a new target for the fiscal balance of a surplus of at least $50 million, demonstrating a commitment to reducing the overall debt burden in nominal terms; and, consistent with the surplus target, a timescale for meeting the existing debt/revenue target of 80%. In our report last year, we proposed that 2028 would be an appropriate time frame.

- **Fiscal strategy and tax reform:** Meeting these fiscal targets will require significant revenue increases, given likely upward pressure on spending. In the absence of a larger labour force it will be difficult for Bermuda to grow its way out of these problems. We continue to believe that over the long term it would be appropriate to raise tax revenues significantly as a share of GDP, in line with other similar economies. We see no reason why Bermuda should not move from the existing payroll tax to a comprehensive progressive income tax, which would allow the proper taxation of capital income alongside labour income. We also think it necessary to increase revenues from multinational companies registered in Bermuda, whether by increasing registration fees or, over the medium to longer term, the introduction of a corporate income tax, which would also make a major contribution to improving Bermuda's position in international negotiations on tax harmonisation issues.

- **Diversification and sustainable growth:** The government's focus on fintech, if pursued prudently, is broadly appropriate, but considerable care needs to be taken given the potential reputational risks. More broadly, the underdeveloped nature of domestic capital markets, and the absence of a domestic market for start-up finance is a concern. We reaffirm our suggestions from last year relating to requirements for financial statements and bankruptcy procedures and some form of target for domestic investment – in viable projects – by the island's private and public pension schemes, which we understand is under review.

- **Reforming immigration policy:** Immigration is a charged political issue for any government, given Bermuda's difficult history; but this cannot be an excuse for inaction. The need for policy change to boost the population of working age and enable stronger economic growth is widely recognised across government, business and much of civil society. Bold action could help kickstart the business growth and job creation – for Bermudians as well as new arrivals – that Bermuda needs to address its immense demographic and fiscal challenges.

- **Spending on healthcare:** The government has now set out an ambitious, radical and in our view broadly sensible programme of reforms. In particular, moving to a single-payer system is likely to be a precondition for successful cost control. Given the complexity of the issues, not to mention the political sensitivities, implementation will inevitably be a difficult and lengthy process. Healthcare represents a significant share of Bermuda's economy that, without action, will only increase. We commend the government's approach to date and urge them to continue on this path in order to sustainably respond to the health care challenges that an ageing population will confront in coming years.

- **Tackling unfunded pension liabilities:** As with healthcare, the government has clearly grasped the scale of the task and has a clear and, we believe, reasonably accurate view of the actions required. We urge a clear focus on raising both the pensionable age and the effective average age of retirement; this will both help address the issue of unfunded liabilities in both public sector and private pension schemes, and hence reduce the associated fiscal risk, and boost the effective size of the working age population and hence economic growth.

- **Government efficiency:** We are encouraged by the various initiatives that have been introduced to streamline and rationalise government services and public sector management and look forward to an assessment of their effects. We also recognise the appeal of a zero-based budgeting approach in the budget process, but believe that focusing on specific areas where there are low-hanging fruit of potential savings is likely to be more successful in securing the budgetary resources needed to achieve fiscal sustainability. We also recommend strengthening the analytic capacity of the Government, most urgently in the Ministry of Finance, but also in respect of climate change.

- **Climate Change:** Bermuda cannot afford to ignore the risks to which it is exposed. We would encourage the Government to carry out an assessment of the economic and fiscal risks that climate change might pose to the island. Furthermore, responsibility for assessing such risks should be vested in a designated government agency, with clear lines of accountability.

The Government has, commendably, made major progress in setting out an agenda for reform of the healthcare financing system and, to a somewhat lesser extent, pensions. But this should not be an excuse for further delay in tax reform and immigration policy. The risk of a significant adverse shock, to which Bermuda remains extremely vulnerable, continues to rise. There is no time to waste.

The Panel looks forward to assessing progress made in a year's time.

A. Introduction

1. This is the Panel's fifth annual report. Jonathan Portes is now the Chair of the Panel, David Peretz having retired, and Marian Bell has been appointed as its newest member.

2. Our role, 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." We are charged with reviewing "progress towards the Bermuda Government achieving a balanced budget by fiscal year 2020/21" 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."

3. In making our assessments we are asked to "review the impact of the most recent Bermuda Government 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."

4. We have had helpful discussions with Ministers and their officials, and as ever are particularly grateful to Anthony Manders, Deborah Harris and the other staff of the Ministry of Finance for their support. We would also like to thank many others on the island who have offered us information and advice either in face-to-face meetings or otherwise (a complete list is in Annex A). However, as in our previous reports, all the judgements and recommendations in this report are our own independent views.

5. Section B summarises our key findings and recommendations from last year and discusses progress since then; section C discusses economic and fiscal developments in Bermuda; and section D reviews relevant external developments and reassesses the uncertainties and risks facing the island. Section E analyses the Budget's projections for the key fiscal indicators and presents our own projections under alternative scenarios. Sections F and G discuss tax and expenditure policy, while Section H addresses the key longer-term issues facing the island: the need for faster economic growth, demographic change (i.e. a rapidly ageing population and a shrinking workforce), health care, pensions and climate change. Finally, Section I summarises our conclusions and sets out our key recommendations.

B. Key Findings of the December 2018 report

6. In our 2018 report, we highlighted Bermuda's vulnerability to external developments and its risk exposure in the event of a severe financial crisis in the global economy. We also highlighted the implications of demographic developments: the island's shrinking workforce and rapidly ageing population, which will put ever-increasing pressure on both taxes and spending.

7. We noted that the high level of government debt, unfunded pension and health insurance liabilities and other contingent liabilities leave the island extremely vulnerable. We stressed the importance of meeting the target of budget balance in 2020-21 (after contributions to the sinking fund), as well as the longer-term targets of reducing debt and debt service, respectively, to 80% and 10% of revenues. And we argued for policies to reinvigorate economic growth, including through a decisive change in immigration practices and policies.

8. We also made a number of specific suggestions and recommendations:

   - **Tax reform.** We recommended that the Government adopt and implement the key proposals of the Tax Reform Commission, although we recognised that a longer timescale might be required for some of its proposed reforms. We reaffirmed our previous recommendations that, over the medium term, the government should seek to increase tax revenues by 2 to 3% of GDP, or about $130-$200 million annually.
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   - **Securing faster growth.** We endorsed **t**he government's aim of diversification away from reliance on insurance and tourism, while cautioning on the need to maintain Bermuda's primary asset – its highly regarded legal and regulatory framework.

   - **Reforming immigration policy.** We welcomed the Government's evident determination to implement fundamental reform of its immigration practices and policies and urged further rapid progress.

   - **Spending on health care.** We argued for rapid action along the lines proposed by the Ministry of Health and the Bermuda Health Council to put downward pressure on future spending.

   - **Government efficiency.** We welcomed the Government's approach to improving efficiency across government.

   - **Tackling unfunded pension liabilities.** We argued that debt reduction needs to be complemented by actions to address the large unfunded liabilities of public sector pension schemes and, potentially, the Contributory Pension Fund (CPF) as well as of the Government Employees Health Insurance (GEHI) Fund.

   - **Debt reduction.** We recommended that the government should set a specific timescale over which it would seek to meet the target of reducing debt to 80% of annual revenue.

9. We recognised that this was a wide-ranging and challenging agenda, requiring action both in the short term, in particular major reforms to the tax system and substantial tax increases, and over the medium to long term, addressing spending pressures in the health sector and from the government's pension and health insurance liabilities for its employees and retirees (and potentially in relation to the CPF). Given the relatively benign domestic and international economic environment, we argued that the case for immediate action was strong. The longer the delay in addressing the large debt overhang, the more serious the underlying issues would become.

C. Economic and Fiscal Developments in 2019

10. Interpretation of economic developments has been complicated by the recent rebasing of GDP data, combined with the implementation of the 2008 international System of National Accounts. This has resulted in a substantial upward revision of the level of GDP of about 14%, to about $7.3 billion in 2018, reflecting greater domestic value added in the financial services sector than was previously measured, as well as a number of other changes.

11. On the new measure, over the last five years nominal GDP growth has averaged about 2 to 2.5% per annum, while real growth has averaged about 1%. In 2018, GDP grew only marginally in real terms, by about 0.1%, sharply down on 3.6% in 2017. Domestic demand, which is arguably a better reflection of the strength of the domestic economy, appears to have been broadly flat. In part, this is likely to reflect that some of the strength of the economy in 2017 was driven by activity related to the America's Cup, especially hotels and restaurants. Growth strengthened significantly in the first quarter of 2019; however, recent growth in retail sales, perhaps the timeliest indicator, has been weak.

12. The overall picture suggests that the economy remains roughly flat. Tax revenues are broadly tracking budget plans, implying the economy is performing roughly as expected overall. The May 2019 Labour Force Survey suggested that the employment rate had risen over the previous year, due to a rise in activity rates rather than a fall in unemployment, and youth unemployment rose. Tourism is a relative bright spot, with the entire increase in employment accounted for by hotels, restaurants and construction. However, continued high levels of youth unemployment and underemployment suggest that there remains considerable economic "slack" (underutilised resources) in the economy, so there is potential for further growth in the near term.

13. The last year has seen little progress in fiscal consolidation. The headline deficit, after contributions to the Sinking Fund, actually rose slightly, from $70m to $78m. This reflects one-off factors, in particular resumption of the block grant payment to the Bermuda Hospital Board (BHB), but overall, once again, this performance was not impressive.

14. In the context of this limited progress, the 2019 Budget was unambitious. The most notable development in overall fiscal policy has been a very considerable loosening of the Government's targets for revenue growth. Compared to the 2018 Budget – which itself represented significant slippage with respect to the 2017 Budget, as we observed last year – the 2019 Budget envisages considerably slower growth in tax revenues, while maintaining the cash freeze on expenditure. The 2018 Budget envisaged total revenues in 2020-21 of $1,189 million; in contrast, the 2019 Budget projects revenues of $1,141million, 4% less.

15. Our analysis of the fiscal position needs to take account of the Government's decision to suspend contributions to the Sinking Fund. In our view, this decision was sensible and appropriate from a debt management perspective, and we make no criticism of this change on policy grounds. Sinking Funds are relatively rare in developed economies with significant levels of debt, and under international accounting standards, contributions to a Sinking Fund do not affect the headline deficit.

16. However, from a budget accounting perspective, the change disguised a further loosening of the Government's fiscal targets. In the 2018 Budget, the target was to achieve budget balance – after contributions to the Sinking Fund – in 2020-21. Had the Sinking Fund contributions not been suspended, the 2019 Budget would have projected a deficit of approximately $60 million in 2020-21; it is only the suspension of Sinking Fund contributions that delivers a very small projected surplus.

17. This slowing in the pace of fiscal consolidation, is largely a result of the Government's decision to reject most of the key recommendations of the TRC. The Government does not intend to proceed with any of the TRC's proposed new taxes, either in 2019-20 or in 2020-21, which were estimated to increase revenue by $96 million per year (after two years). Nor has it accepted some other significant revenue-raising measures, such as increasing international company fees. Instead, in 2019-20, it accepted some of the TRC's more minor recommendations for changes to existing taxes (such as increasing the foreign currency purchase tax), and continued with implementation of previous changes, such as bringing some dividend income of employees within the payroll tax.

18. The Government argued that its decision to reject a number of the TRC's key recommendations reflected a number of factors: the uncertainty caused by the EU's - now superseded - decision to place Bermuda on the blacklist of non-cooperative tax jurisdictions, concerns over additional tax burdens on those dependent on rental incomes, particularly pensioners, the risk that a rise in international company registration fees might result in an exodus of company registrations, and a more general desire not to raise living costs for ordinary Bermudians.

19. Nevertheless, the 2019-2020 Budget did include some changes to tax rates and structures, including:

- The elimination of taxes on mortgage refinancing;

- Payroll tax relief for businesses hiring local musicians;

- Targeted employer payroll tax concessions for retailers in the fashion, shoes, jewellery and perfume sectors;

- Increased customs duties on sugar-related products, cigarettes, tobacco, and beers, wines and spirits, as recommended by the TRC; but also, extension of the hotels and restaurants temporary customs duty relief for a further five years. The net impact is estimated to be an increased yield of about $5.5 - $7.5 million per annum;

- An increased financial services tax on local insurance premiums and bank assets, yielding $3.4 million additional revenue per annum;

- An increased foreign currency purchase tax, yielding about $4 million;

- Increased land taxes (as a substitute for the TRC's recommendation for a new tax on rental income) raising about $10 million; and

- A new tax structure for cruise ships and cruise ship passengers, expected to generate additional revenue of about $10 million.

20. While the full cost of some of the new tax relief measures is not entirely clear from the published Budget, the net impact of all these changes is that the Budget forecasts only a very modest increase in tax revenues in 2019-20 (approximately $30 million, or less than 0.5% of GDP).

21. Revenue growth in 2019-20 is projected to be less than 3% over the original estimate for 2018-19, and for the two years after that is only about 2% per year. This is about half the rate foreseen in the 2017-2018 Budget, and, given inflation, effectively means no significant change in real terms for the entire Budget forecast period.

22. Moreover, and perhaps more importantly, the Budget provides no indication of the Government's future tax strategy, either with respect to overall fiscal objectives or as to the structure of the tax system. It appears to signal that, rather than seeking to modernise and broaden the tax base, with the objective of a sustained rise in the revenue/GDP ratio (as our previous reports had recommended), the Government has no plans to change the current tax structure in the foreseeable future.

23. The Budget does, as recommended in several of our previous reports and by the TRC, incorporate a much more determined effort to improve the efficiency and timeliness of tax collection, by increasing the resources of the Office of the Tax Commissioner, modernising payment methods, and improving enforcement. We are impressed by the pace of the modernisation effort in the Tax Commissioner's Office. The Government should continue to attach a high priority to ensuring that this work has the necessary political and financial support.

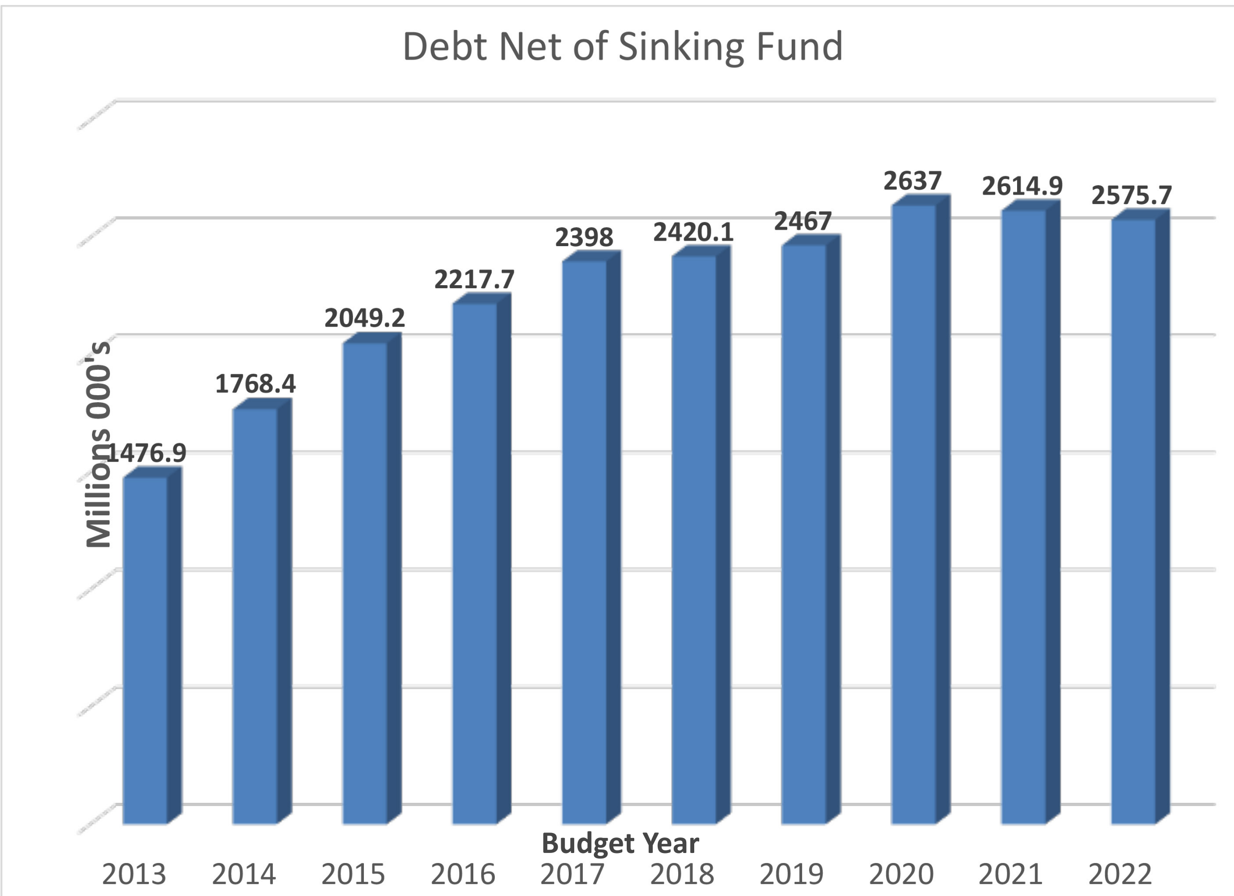
24. On the expenditure side, the Government has maintained the policy of a freeze in cash terms. However, the Government has signalled its intention for a major reform of the health sector which, over the longer term, could have the potential of significantly reducing expenditure pressures, as well as having wider social and economic benefits. These are discussed in more detail in section H below.

25. A final factor that will influence fiscal strategy has emerged since the issuance of the Budget. In 2016, the then Government provided loan guarantee agreements to lenders who had financed the Caroline Bay development at Morgan's Point. In August, the original debtors announced that they were in technical default and unable to meet their contractual obligations. To buy out the debt, the Government in September undertook a new line of credit with local banks of $200 million and, since then, it has drawn $170 million, largely to make payments to lenders. To facilitate this new line of credit, the Minister asked Parliament to raise the Government's debt ceiling by $250 million.

26. Thus, unexpectedly, there has been a sharp and discrete increase in Bermuda's public debt to over $2.6 billion (net of the sinking fund), raising the debt-revenue ratio to about 2.35, a level

comparable to that of 2015 when this Panel was initially constituted.[1] It appears possible that the Government will also be forced to make further payments to cover the cost of unpaid bills to contractors associated with the suspended work on the project. As yet, it is unclear what recoveries, if any, the Government will be able to make from the developers' assets

27. This development constitutes a major setback to the Government's fiscal consolidation programme and raises obvious further questions about the Government's issuance of guarantees, and other off-balance sheet liabilities of roughly $385 million (mostly relating to the Bermuda Hospital Board), which may impact the future creditworthiness and hence the financing costs of the Government. While it does not immediately affect the deficit, the extra debt assumed will raise future interest payments, increasing the deficit as well as the debt to revenue and the debt service to revenue ratios.



1 In accordance with standard government accounting procedures, the calling of the guarantee increases net debt (by bringing a contingent liability onto the government's balance sheet) but has no direct impact on the deficit. However, since additional borrowing is required, the resulting interest payments will increase the deficit in 2019-20 and subsequent years.

28. In recent years, the Government has been commendably effective in managing its debt, with recent refinancing operations resulting in reduced debt service costs. This has meant that rising debt has not been translated into a commensurate rise in debt interest costs. And with no significant outstanding debt coming due, the Government should not require additional borrowing from the market until 2022, other than to refinance the bank loan incurred to purchase the debt for Caroline Bay.

29. But, while this is welcome, it should not be grounds for complacency. Financing conditions in international markets can change quickly, either because of a loss of confidence in the Government's fiscal strategy, or as a result of unrelated market developments. Nor, in our view, should the Government take comfort in the relatively sanguine attitude of the ratings agencies, which are generally a lagging indicator - that is, by the time they raise the alarm, it is already too late.

D. External Developments, Uncertainties and Risks

30. The external environment facing Bermuda has darkened since the Panel's last report. Despite easier monetary policy, global growth has slowed amid rising trade tensions, particularly, but not exclusively, between the US and China, and is expected to remain weak in 2020. Trade in merchandise goods was flat through the first half of 2019, leading the World Trade Organisation to forecast that world merchandise trade growth would slow from 3.0% in 2018 to 1.2% this year, the slowest growth since the financial crisis, only picking up to 2.7 per cent next year if the global trade disputes are settled. The continued uncertainty and unpredictability of policy has contributed to weak fixed investment and productivity growth, exacerbating the slowdown.

31. In its recent World Economic Outlook, the International Monetary Fund (IMF) again revised down its forecast for 2019 world growth, to 3.0%, the slowest growth since the financial crisis, with a slight but patchy and precarious pick up forecast in 2020. The picture for the advanced economies is worse. Growth for advanced economies is projected by the IMF to slow to 1.7% in 2019 and 2020, with the four major 'systemic' economies (the USA, euro area, China and Japan), which account for almost half of world GDP, continuing to slow into 2020 and beyond. The United Nations (UN) has warned of the possibility of a world recession in 2020.

32. The global slowdown has been geographically widespread and synchronised. The long economic expansion in the US, Bermuda's largest trading partner, has extended into its tenth year, but momentum has waned, leading the Federal Open Markets Committee to move away from its tightening stance and cut the key Federal Funds rate three times in 2019 as well as ending balance sheet reduction. The IMF expects US growth to slow from around 3% in 2018 to 2% in 2020, easier monetary policy notwithstanding. Growth in China has also slowed in response to trade tariffs and slowing domestic demand. The UK and parts of Europe are teetering on the brink of recession as uncertainty over the timing and nature of Britain's exit from the European Union (Brexit) exacerbates the slowdown in world trade and automobile manufacture. Growth in emerging markets has also slowed to its weakest rate since the financial crisis a decade ago but is expected to pick up next year.

33. The worsening world economic outlook notwithstanding, risks, as last year, remain predominantly on the downside, and are "elevated" in the words of the IMF. Trade conflict that has focused on merchandise trade threatens to spread to capital markets. Among several geopolitical risks, escalating tensions in the Gulf could lead to significantly higher oil prices. The most damaging form of Brexit remains a possibility, despite the best efforts of the last UK parliament, and there are domestic policy uncertainties elsewhere.

34. "A realisation of (these) risks could lead to an abrupt shift in risk sentiment and expose financial vulnerabilities built up over years of low interest rates" according to the IMF. Debt levels are high, increasing the risk of a widening of risk spreads and a repricing of financial assets, hurting those institutions, including insurance companies, which have invested in corporate bonds in a search for yield. In its recent Financial Stability Report, the IMF stated: "In a material economic slowdown scenario, half as severe as the global financial crisis, corporate debt-at-risk (debt owed by firms that are unable to cover their interest expenses with their earnings) could rise to $19 trillion—or nearly 40% of total corporate debt in major economies—above crisis levels."

35. Moreover, with policy interest rates in many economies still close to the effective zero lower bound amid low inflation expectations, and little appetite for active fiscal policy, there is concern that there may be a lack of room for manoeuvre to stimulate developed economies should the slowdown worsen. This is particularly true of Bermuda given the absence of an independent monetary policy and its own sizeable debt burden.

36. Reflecting the slowdown, the anticipated monetary policy response and increasing risk aversion, government bond yields have fallen along the yield curve in the major economies. US ten-year Treasury yields are trading below 2 per cent, down from in excess of 3 per cent at the time of the Panel's last report, though up from the lows of the summer. While this likely will have affected Bermuda's investment returns on its strong external asset position, the Government still expects to finance its debt at these historically low interest rates. Future funding is less certain, however. The IMF reports that "vulnerabilities are also present in the global US dollar funding markets. US dollar funding fragilities amplify adverse shocks and create spillovers to countries that borrow in US dollars from foreign non-US banks" (Financial Stability Report, October 2019).

37. Climate change continues to be a major and growing threat. According to the UN "global emissions are reaching record levels and show no sign of peaking. The last four years were the four hottest on record, and winter temperatures in the Arctic have risen by 3°C since 1990. Sea levels are rising, coral reefs are dying." As a small island nation, Bermuda is particularly vulnerable (see section H).

38. Due to the importance of the insurance and reinsurance sector to the economy of the island, Bermuda is also vulnerable to insurance losses from extreme weather events and natural catastrophes. For now, the reinsurance market appears well capitalised with the capacity to deal with increasing extreme weather and natural catastrophe events, benefiting from increased investment returns, higher premiums and increased insurance penetration, but this could change in the event of a series of adverse events. The Bermuda Monetary Authority (BMA) and the UK's Prudential Regulatory Authority (PRA) are currently conducting joint stress tests of insurers, the results of which are expected to be made available to Chief Executives in the first quarter of 2020.

39. Bermuda, together with Barbados and Aruba, was added to the EU's blacklist of non-cooperative tax jurisdictions in March as the country narrowly failed to meet a deadline for enacting acceptable amendments to legislation complying with economic substance rules. However, following a meeting of EU finance ministers in May, it was announced that Bermuda had committed to addressing EU concerns, particularly on economic substance for collective investment funds, and had therefore been moved to a so-called grey list of countries still under EU scrutiny for their tax practices, and been given until the end of 2019 to be fully compliant. We understand that Bermuda is currently fully on track to meet this deadline.

40. In addition, recent OECD proposals on corporate taxes—the Base Erosion and Profit Sharing (BEPS) Pillar 2 - calling for a minimum global tax rate for corporations has been mandated by the G20 to be effective by or before the end of 2020 and to operate in tandem with BEPS Pillar 1, which involves the sharing of taxing rights between countries. While both the timing and implementation of any such measures remains highly uncertain, the direction of travel seems clear, and raises medium-term concerns on the potential impact on Bermuda's attractiveness as a base for international corporates.

41. In view of the importance of the financial services sector to the economy, Bermuda's reputation as a well-regulated jurisdiction complying with international standards, and the risk that trade restrictions might spread to financial services, it is imperative that the jurisdiction satisfy Caribbean Financial Action Task Force (CFATF) anti-money laundering and anti-terrorism financing procedures. The effectiveness of these controls is currently the subject of CFATF "mutual evaluation." This was discussed extensively in our previous reports, and we noted the considerable efforts being made by the Government to ensure a favourable outcome. The final results have not yet been made public, but the process appears to be reaching a conclusion.

42. Bermuda must also continue to engage with international regulatory bodies to ensure continued compliance, including with EU Solvency II equivalence, any similar requirements imposed by the UK after Brexit, and the US National Association of Insurance Commissioners "qualified jurisdiction" requirements.

43. As the above discussion shows, Bermuda has responded flexibly and appropriately to a variety of international regulatory pressures and issues over previous years. However, such pressures are not likely to diminish and, particularly in respect of taxation, may well intensify.

E. Future Fiscal and Debt Prospects

44. What does the slowdown in fiscal consolidation, as well as the extra debt resulting from the Caroline Bay default, mean for Bermuda's fiscal prospects? By the end of the Budget forecast in 2021-22, the Budget is projected to be in surplus by about $47 million, taking account of the increase in debt interest payments resulting from the Caroline Bay debt. This does mean that net government debt will be falling, although, had the Sinking Fund contribution not been suspended, there would still be a deficit, on the previous definition, of more than $10 million. It is worth noting that when the Panel was originally appointed, the Government's target was to eliminate the deficit, after Sinking Fund contributions, by 2018-19. On current plans, this will not have been achieved by the end of the current budget forecast period, three years later.

45. Given the recent addition of debt related to the Caroline Bay Project guarantee, the debt to revenue ratio would remain significantly above 200% throughout the forecast period, compared to the Government's target of 80%. The debt service to revenue ratio would be about 10% (roughly in line with the target, but largely reflecting the continued low level of global interest rates).

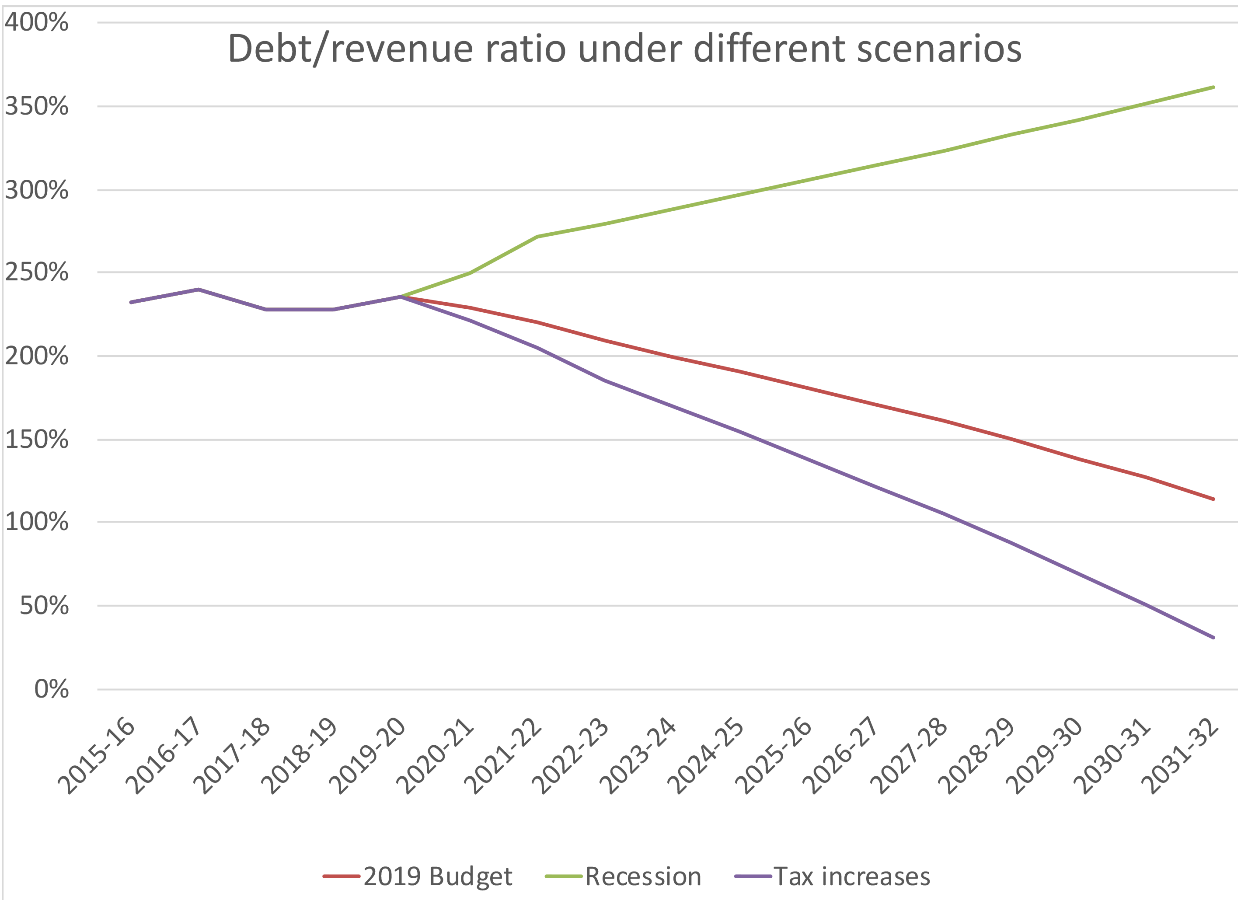
46. Moreover, even these projections may be optimistic, given previous performance. With an election no later than 2022, increases in expenditure cannot be ruled out.

47. As in previous years, we show the possible evolution of the key debt/revenue ratio under different scenarios.

    - The "base case" is consistent with the 2019-2020 Budget. Revenue and expenditure (excluding debt interest) are assumed to grow at 3%, roughly the expected trend growth of nominal GDP, after the end of the budgetary period in 2021-22. We assume that the interest rate payable on Bermuda Government debt rises gradually, to 6% by 2024-25. Under this scenario, the debt/revenue ratio falls gradually, only hitting the Government's target of 80% by 2034-35. This is six years later than under the base case we presented last year, showing the impact of the slowing pace of fiscal policy consolidation as well as the impact of the extra debt resulting from the Caroline Bay liability. This scenario, which represents our best estimate of the impacts of current policies, is not disastrous, but means very slow progress indeed on debt reduction; Bermuda would remain vulnerable to a fiscal shock for the foreseeable future.

    - Under a "recession" scenario, we assume that tax revenue falls by 2% a year in cash terms in 2020-21 and 2021-22, after which growth resumes; while expenditure grows at 3% per year. This could be the result of an economic slowdown, either domestic or resulting from international developments; and/or a relaxation in fiscal policy in the run up to an election. We also assume a significant, but plausible, further increase in the effective interest rate payable on Bermuda Government debt, to 7%. Under this scenario, the budget deficit reappears in 2020-21, and remains a permanent fixture. The debt-revenue ratio rises throughout the 2020s and early 2030s, peaking at more than 375%. In practice, it is highly likely that this scenario would at some point lead to complete loss of market access to financing (a "sudden stop"); in such an event, emergency fiscal measures – that is, tax increases and/or spending cuts - would be necessary.

- Finally, we model a scenario under which additional tax rises are implemented in 2020-21 and in each of the subsequent two years, of an additional $25 million in each year (so an extra $75 million in the final year, compared to the baseline). We consider that this represents an economically and administratively realistic approach – it would be equivalent to implementing the bulk of the unimplemented recommendations of the TRC. This would result in a rise in the revenue/GDP ratio to about 16% (on the basis of the new approach to measuring GDP) - still low compared to similar small island economies. It would result in a budget surplus of about 1.6% of GDP by 2022-23 (and for all subsequent years), which in turn would allow the revenue/debt target to be met by 2029-30.



48. The negative scenario illustrated here is not in our view alarmist – it is far from being out of line with Bermuda's historical experience – the very sharp rise in deficits and debt after 2008 demonstrates how quickly the fiscal position can deteriorate. It thus illustrates the continued vulnerability of Bermuda's public finances to negative shocks, internal and external, and emphasises the need for continued progress to ensure that Bermuda is in a position to withstand such shocks.

49. Moreover, all of these scenarios assume continued spending restraint throughout the budget period, with spending initially held constant in nominal terms, followed by relatively modest growth. We have previously noted the additional pressures on spending resulting from the

island's extremely negative demographic dynamics, combined with a comparatively expensive health financing system, and the potential impact of these factors on the public finances, even if spending elsewhere is restrained. As noted elsewhere in this report, we commend the Government's current efforts to reform the system of health financing and consider some pension reforms, both of which have the potential to limit future spending increases; nevertheless, significant risks remain here also.

50. These scenarios are only illustrative and will not in practice materialise in the forms shown here. But they do illustrate the broad choices facing Bermuda: continuing with an incremental approach to tax and spending, which will leave the island vulnerable to adverse shocks, whether of domestic or foreign origin, which would have extremely negative consequences; or a determined effort to increase revenue generation, which will make the fiscal position more resilient to such shocks while freeing up fiscal space to deal with the inevitable pressures on spending resulting from the island's demographic position.

51. Our projections show the favourable impact of an increase in tax revenues over the short to medium term. If they were broadly on the lines set out by the TRC, this would allow some accommodation of medium-term spending pressures while ensuring debt is on a reasonably rapid downward trajectory.

F. Regaining the Initiative on Tax reform

52. Since its first report in late 2015, the Fiscal Responsibility Panel has emphasised that to achieve fiscal sustainability in the context of high levels of public debt and the fiscal demands that will arise from a shrinking and ageing population, Bermuda needs to mobilise a higher share of government revenues in GDP (indeed, the recent large upward revisions in Bermuda's GDP further underline just how low Bermuda's revenue mobilisation rate is). Based on comparable island economies with high per capita incomes, we advocated an increase of 2-2½% of GDP. The focus of our tax reform policy recommendations centred on a broadening of the tax base and most importantly, on a shifting toward greater balance in the burdens borne out of wages relative to capital income.

53. There has been no shortage of detailed expert proposals during the last 5 years. The IMF's Caribbean Technical Assistance Centre produced a detailed set of recommendations in 2015.[2] The previous Government proposed several reforms in tax policy, including the introduction of a General Services Tax (GST), for phased implementation. It also began the equally challenging task of addressing serious weaknesses in Bermuda's tax administration capacity, involving both an increase in staff, strengthened audit procedures and enforcement measures, and software system reforms, an initiative continued by the present Government.

54. Some policy reforms were implemented during the remainder of the tenure of the previous Government. These included a reform of the payroll tax which introduced a greater degree of progressivity and some increases in customs duties and excises. The current Government also followed through with applying the payroll tax to income paid as dividends and, in the area of

2 This 2015 confidential report was subsequently published in October 2017 by the current Government.

tax administration, removed the freeze on posts in the Office of the Tax Commissioner. Tax administration reforms continue to be implemented, though they remain focused on collecting revenues from the existing tax base (rather than one which would entail collection of data on presently untaxed sources of capital income).

55. However, other reforms that were scheduled to be implemented, including the GST, were put on hold by the newly elected Government in mid-2017 as it sought the guidance of a newly established TRC. In its 2018 report, this TRC advocated policy reforms (see above) that would have significantly bridged the remaining gap in the revenue share and allowed for some rebalancing of the revenue shares derived from capital and wage income.

56. Although reforms that would have raised $50 million in additional revenue were signalled in the pre-Budget Report to be part of the 2019-2020 Budget, the actual Budget chose instead to concentrate on incremental increases in existing taxes. While recognising the Government's concerns over the impact of tax rises both on business and citizens, the Panel still believes that Bermuda cannot achieve its debt sustainability goals in the absence of further tax policy reform measures. Without addressing the unbalanced focus on taxing wage incomes rather than capital incomes, Bermuda will be shackled in its ability to increase employment, particularly over a medium to longer term characterised by an ageing and shrinking population.[3]

57. Reiterating our previous views, we believe that it is essential to achieve greater equity by reducing taxes for those at the bottom of the pyramid while extending taxes to those with significant capital income or assets. Over the medium term, there are strong arguments, on grounds of both equity and efficiency, to move to a comprehensive and progressive personal income tax that taxes both employment and capital income, as is the case in most other countries. This would require major changes in Bermuda's legal and administrative framework, and would require careful preparation, but it would be both realistic and sensible to set this as the long-term objective.

58. Meanwhile, as an interim step, we reiterate that a withholding tax on dividend and interest income would help redress the current imbalance between taxes on labour and those on capital. We also believe that a well-designed annual rental tax - one that exempts all but larger properties and owners of multiple units -— would raise revenues and tax the wealthiest owners of capital, exempting most homeowners. We also reiterate that the introduction of a GST, as recommended by our previous reports and other independent bodies, would bring Bermuda in line with normal practice in other jurisdictions. The Government should also consider the scope for introducing, or increasing, carefully structured taxes designed to change behaviour in a positive way, including taxes on sugar and other unhealthy products and, perhaps, a carbon tax.

59. While uncertainties remain in respect of international regulatory developments – and indeed in respect of numerous other international developments – these uncertainties do not appear

3 In his 2019-20 Budget Speech, the Finance Minister recognised the importance of "significant structural reforms" to facilitate "more Bermudians working in Bermuda and…more jobs located in Bermuda to ensure we collect the revenue necessary to fund our pensions and care for our seniors."

to be significantly greater than in the past, nor is there any reason to believe they will be fully resolved in the near future. We do not accept that they constitute a case for further delay. Indeed, in the case of a corporate income tax, they argue for preemptive action,especially to reflect the burden of taxes already borne by Bermuda's corporations.

60. On corporate taxes, we note that the government rejected the TRC's recommendation for a substantial increase in registration fees for international companies on the grounds that such companies would simply move. In our view, excessive reliance on highly mobile companies with no economic presence in Bermuda is simply not a viable long-term strategy. Instead, we recommend that the Government bite the bullet – and get ahead of the game – by considering how, over the medium to longer term, the introduction of a modest, and carefully structured, corporate income tax could both boost revenues and address the growing international pressure to crack down on jurisdictions that impose no or very low corporate taxes.

G. Expenditure reform initiatives

61. The 2019-20 budget did not contain significant changes in the structure of public spending, either capital or current, in Bermuda. Indeed, as in previous years, the Government has simply frozen current spending by departments at 2018-19 levels (though not through a freezing of staff positions as with the previous Government). During this last year the Efficiency Committee (which was chaired by the then Junior Minister of Finance) continued its efforts to review the functioning of all Government departments. The Committee made a number of proposals seeking to both improve efficiency and realise financial savings.

62. In addition, the Premier announced a new public service reform initiative that would seek to transform Bermuda's public services, starting with the reorganisation of the top level of public services. As part of this, the Government also intends to reintroduce Zero Based Budgeting (ZBB) in the budget formulation process for 2020-21 as a means of prioritising expenditure. However, as yet, we have seen little evidence that such initiatives have translated into meaningful savings or efficiencies in key spending programmes. As with tax, Bermuda does not lack expert reports or policy recommendations; implementation and delivery are essential.

63. In some areas, this requires a strengthening of the Government's analytic capacity. In particular, we are struck by the excessive pressures on the Ministry of Finance, which does not currently have the capacity to support the Finance Minister appropriately, given his roles both in domestic economic and fiscal management and international negotiations. This shortfall should be addressed. We also note the absence of resources needed to assess the complex and severe risks posed by climate change.

64. The Government should also draw lessons from the recent experience with the Caroline Bay Project Guarantee. In general, it should be very cautious in providing off-budget financial guarantees for private sector borrowing, particularly for mainstream commercial projects such as hotel or tourism-related developments. Any such guarantees should be appropriately structured to ensure that the risk to the taxpayer is no greater than absolutely necessary.

65. This caution also applies to the Government's proposals to introduce new mortgage guarantee schemes. International experience suggests that it is very difficult for governments to avoid such schemes resulting in significant risk transfer to taxpayers – this means that as well as achieving the primary objective of short-term financial support for homeowners, the impacts may also include higher house prices (disadvantaging new buyers), excess profits for banks, and, in the event of an economic downturn, large losses to the public purse.

H. Long-Term Issues

66. The Minister's 2019-20 Budget Speech highlighted the important implications of the Population Census of 2016. It emphasised that the ageing of Bermuda's population and the forecast of its further shrinkage - "the most serious long-term issue Bermuda faces" - could have profound implications for Bermuda's economic growth and for the financial viability of its pillars for social welfare embodied in its various pension, health and welfare schemes. It raised important questions on the role that immigration reform could play in assuaging these potential developments. These issues were extensively discussed in our Panel Report of 2018 and as discussed below, continue to be important elements of the Government's policy agenda.

Immigration Reform

67. The Panel has consistently emphasised the importance of immigration as one lever that can help to address the challenge of an ageing and shrinking population. Immigration can potentially both increase economic growth and help finance an increasingly stressed social insurance framework. The contribution to growth will be critical. It is unlikely that an increased activity rate and productivity growth will compensate for a shrinkage of the labour force that will derive from a fall in the absolute number of workers in the working age group. Even with efforts to incentivise later retirement, pressures on labour force participation will arise as many individuals (largely women) feel forced to serve as carers for dependent seniors. Moreover, many of the brightest young Bermudians still appear incentivised to work abroad.

68. While some of Bermuda's key industries can rely on a flow of high-skilled professionals that are resident for a few years at a time, many of its skilled workers are torn between a desire to continue working in Bermuda and restrictions on the prospect that they and their dependents can ultimately live and work in Bermuda as citizens. This in turn lessens their commitment to the island, reduces their incentive to invest, makes them more likely to return to their countries of origin, and makes Bermuda less attractive both for businesses and people. Treating people who have spent many years of their lives contributing to the island's economy simply as economic units, rather than offering them a stake in the future of Bermuda, is ultimately counterproductive, both socially and economically.

69. Nor is it a question of creating jobs before inviting people to come here – that is to put the cart before the horse. Without access to workers with the right skills, entrepreneurs will not create new businesses or expand existing ones, nor will they secure the finance they need. Lack of immigration is in itself a major obstacle to job creation. International experience clearly shows that a liberal environment for immigration, by allowing business creation and growth, creates jobs, both for new arrivals and crucially for existing residents. The same can be true of Bermuda.

70. A shrinkage in the financing base in support of pensions and health insurance in the face of increasing demand for these income flows from an increasing number of retirees will further strain the social fabric. Without a wider population base, the Government will be forced to either cut benefits or further increase the contribution base—the former would be politically difficult, while the latter would undermine incentives for business investment and employment. Put in the simplest possible terms – as several of those we spoke to, from both the public and private sector, did – Bermuda needs more people.

71. The Panel is mindful that immigration reform is a politically charged issue with deep and painful historical roots. Creating a pathway to citizenship was a contentious issue for the previous Government, and we note the continued delay by the Government in moving ahead this year on even the least contentious of the immigration reforms that were tabled by its Immigration Reform Group in early 2018. These reforms would have facilitated citizenship eligibility for individuals from mixed status families (such as those who were born in Bermuda of noncitizens or who are noncitizen partners of Bermudians).

72. Good progress has been made in improving Bermuda's administrative practices in relation to work permits. Much more is planned, and we were impressed by the clear determination of both Ministers and officials to make a step change to a modern, largely paperless, and much less arbitrary system, while at the same time impressing on companies their clear moral obligations to train and develop local talent. All this is very welcome and a major improvement on the status quo when we began our work four years ago.

73. But, in the absence of fundamental legislative reform – and perhaps even more important, a change in wider public attitudes towards long-term residents born outside the island but who share a commitment to its future – this will have diminishing returns. And, as with other difficult issues, whether it be the income tax, pension reform, or health care reform, Bermuda will soon run out of time if it hopes to avoid even more painful outcomes. This is not only the observation of this Panel. It also reflects the views of the Government, as highlighted in the Minister's Pre-Budget Report of 2019-20. The time for action is now, and, despite the political difficulties, we call on all stakeholders to assume their responsibilities in the long-term interests of Bermuda's people.

Enhancing the Efficiency and Cost Effectiveness of the Health Care System

74. Some of the most important policy developments in 2019 relate to the Government's efforts to rationalise the financing of the health sector. Bermuda has a high-cost medical care system. It is both limited in the range of its medical capacity (as a small island country) and confronts both the rapid ageing of its population (affecting both the distribution of its citizens across age groups and the risk of a shrinking population and financing base) and many citizens with illnesses requiring chronic care. Without changes to its approach to the provision of medical and health care, in the life-style behaviour of its citizens, and in the way in which they seek health care services, Bermuda faces the prospect of a steadily increasing burden of medical care outlays. This would add to the Government's prospective expenditures, increase the burden borne by citizens and employers for health care premia (impairing the prospects for firms' employment decisions), and further accentuate inequality in the access to medical care. These

pressures were exemplified in February when the Government raised premiums by 5.4% for the GEHI Fund for both staff and retirees (in accepting the 2016 recommendations of its actuaries). They are further illustrated by the evidence that even this increase in GEHI premiums now appears inadequate. The most recent actuarial review of the GEHI Fund in May 2019 indicates the need for an immediate increase of about 12% in GEHI monthly premia.

75. In 2019, the Government initiated a number of steps that will begin to apply downward pressure to the cost curve for medical care in Bermuda, and more importantly, shape the long-term environment for promotion of better health and the financing burden of medical care.

a. Initial Health Care Reform steps in 2019

76. Six immediate policy actions were legislated at the beginning of the fiscal year. First, the Government increased the health insurance premiums of those enrolled in the GEHI Fund (by 5.4%) and the structure of the mandated Standard Premium Rate (SPR). Second, revising the Health Insurance Act of 1970, the Government enabled continuation of its program for home-care benefits, allowing payment to people caring for elderly and disabled people in their homes (potentially reducing the incentive to use BHB inpatient facilities for this purpose). Third, for these benefits, the Government also broadened its regulatory criteria governing the provision of this benefit, refining the criteria for determining eligibility for those residents not already grandfathered-in under the existing subsidy schemes for the elderly (viz. the Health Insurance Plan (HIP) and Future Care).[4] In principle, this could be seen as a first step towards a more equitable criterion for subsidising medical care for the elderly[5].

77. Fourth, the Bermuda Health Council (BHeC) has put a hold on the extension of any new services by medical care providers that would be covered under the Standard Health Benefit. As the technology of medical care becomes increasingly sophisticated and costly, this thus limits the potential exposure of the health insurance financing system to new and more costly treatments or pharmaceutical options.[6] Fifth, in relation to overseas medical care, the government applied more stringent criteria to HIP and Future Care coverage by overseas providers outside the Health Insurance Department's preferred networks.

78. Finally, the government restructured the SPR to ensure funds intended to cover Standard Health Benefits (SHB) provided by the BHB are directed to this specific purpose, while also shifting the BHB's responsibility for the provision of services that are included in the SHB. Without this policy change, the SPR would have had to increase by 23.6% from $355.31 a month to $439.32 per month. Instead, the Government decided on an alternative strategy, with the objective of realising $20 million in efficiency gains so as to avoid the need for a SPR increase. Several changes were thus introduced: the Government increased the provision of

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4 Presently, the only means testing in Bermuda occurs with respect to eligibility for the Government's limited Financial Assistance program, which has restrictive criteria related to property ownership. Given the absence of an income tax in Bermuda, this implies limited flexibility to apply such conditionality.

5 Presently, the Government provides a 70% subsidy for medical care for all citizens aged 65-75 and an 80% subsidy for those over age 75.

6 This change is intended to be temporary, pending discussion on reforms under the new Bermuda Health Plan (see below), and does not preclude new services being covered by local insurers outside the context of the SHB.

Mutual Reinsurance Fund (MRF)-block grant financing to the BHB to $330 million[7], with the explicit understanding that the BHB would introduce efficiency improvements to achieve the requisite financial savings. Also, the BHB reduced its reliance on fee-for service arrangements and expanded the medical services for which the BHB is responsible. It was also understood that BHB cash reserves would finance any unanticipated excess outlays of the BHB, with such funds effectively coming out of the BHB's own financial reserves or profits.

79. Improving the BHB's operational procedures could provide an important short-term gain to the overall efficiency of the health care financing system. But given both demographic trends and the increasing cost of medical care technologies, other approaches will be needed to further shift Bermuda's cost curve downward. This underscores the need for the major policy reforms that are now being developed.

b. Prospective Reforms

80. In 2012, the Government commissioned an important study of alternative possible approaches to its health insurance system. Last year, the Panel was told that a reform initiative would be announced at the beginning of 2019-20.[8] In early August, the Government announced its intention to establish a unitary health insurance financing system sometime in 2020 that would both promote greater equality in the access to health care and shift towards a more preventive approach in the provision of health services.

81. Under this new Bermuda Health Plan 2020 (BHP2020), all residents will be eligible for greater access to primary care and certain prescription drugs as well as reduced co-payments (relative to the previous SHB). This would apply whether a citizen is under the new scheme (which would be a mandated component, as with the previous SHB, under existing private employer-financed insurance plans), the HIP (for those not insured under employer plans) or Future Care (for seniors). It is expected that employers may still offer supplementary health insurance schemes for their employees in order to provide additional benefits to those mandated under BHP2020 benefit provisions. Further, BHP2020 aims to shift from a fee-for-service basis for the charging for care by primary care providers to financing on a capitation basis.[9]

82. The hope is that this reform will encourage greater efficiency by primary care providers, more time spent by physicians with their clients, and greater emphasis on encouraging healthier lifestyles (concerning diet and exercise). A unitary financing plan is envisaged, with "everyone in Bermuda in one large insurance group, instead of fragmented across multiple insurers and groups." Thus, one might envisage all premiums under the SPR, HIP, Future Care, and potentially GEHI being accumulated under one financing umbrella, supplemented

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7 Prior to this change, the MRF received $91.57 of the SPR (of $355.31), which was intended to principally cover low-cost insurance plan support and dialysis care. The rest of the SPR funds went to Hospital Inpatient Services ($100.06), Emergency Service ($48.84) and Hospital and Community Outpatient Services. After the change, almost all of the SPR will be allocated to the BHB, with only the community outpatient services component continuing to receive SPR support ($23.34), with the bulk of this for diagnostic imaging and home medical and support services.

8 The "2012 Report on a Health Financing Structure" (available on the website of the BHeC).

9 Capitation involves providers being paid a "set fee per patient to provide all necessary services to a patient for a defined period of time." A fee-for-service approach will still apply for specialized medical care.

by the Government's block grant to the BHB for patient subsidies for children, seniors and the indigent. Administration of the system is envisaged to be done by "an entity financially and administratively separate and independent from the Government." The plan also aims to reduce the financial burden borne by many households for their health insurance.

83. Since August, the precise details of BHP2020 has been the focus of a 4-month consultation period with insurers, medical providers, businesses, seniors, and the community at large. These discussions are expected to clarify what benefits would be included under the new plan and to develop a road map "as to how [the government] will effectively transition…health financing from the current, disjointed, expensive methodology towards a unified system." Further discussions by soon-to-be established Working Groups are anticipated as more precision is provided on the details of BHP2020 as well as on the locus of responsibility for administration of the new plan.

84. The Panel applauds the Government's initiative to address a very complicated but important fiscal issue. It recognises the challenging task ahead for the Government in seeking to reform a well-established health care financing system that has conditioned the behaviour of employers, citizens and health care providers. The objectives being sought appear eminently sensible, and broadly in line with the health financing reforms of other industrial countries faced with the challenges of an ageing population. In particular, it is very difficult to see how meaningful cost containment can be secured without the proposed shift to a "single-payer" model, which can use its monopoly purchasing power to drive down prices.

85. The Panel concludes that the Government should continue to pursue what will inevitably be difficult and contentious reforms. Securing compliance and acceptance by all affected groups will be an important and critical task for the Government. These challenges highlight the extent of the risks faced for fiscal policy, since securing the desired return in terms of a lower cost curve for health care in the context of an ageing population is by no means certain.

Addressing the rising cost of pensions

86. The Pre-Budget Report of 2019-20 sets out the Government's concerns about the $1 billion in unfunded liabilities of the Public Sector Superannuation Fund (PSSF) and the Ministers and Members of the Legislature Pension Fund (MMLPF) that had been revealed in a 2017 actuarial valuation. Since then, the Government commissioned its actuaries to undertake 75-year sustainability projections to clarify the financial impact of the policy reforms previously suggested by its Pension and Benefits Working Group (PBWG). These included a change in the final average earnings definition used for calculating a retiree's pensions; an increase in the normal retirement age (NRA) for an unreduced pension (from 60 to 65); application of actuarial reductions on early retirement prior to the NRA; and an increase in contributions by participants and Government.

87. The actuaries confirmed that all these reforms, if applied to ***all*** existing and future members of the PSSF, would indeed be required to achieve long-term sustainability of the PSSF. It underscored that additionally a 1 percentage point increase in both employee and employer contribution rates would be needed. Limiting such policy changes to only those hired on or

after 2017 would require a contribution rate increase from all employees and the Government of 2 percentage points. Alternatively, an increase of the NRA to 67 (with actuarial reductions for early retirement prior to 67) would generate very significant savings if implemented, with no additional contributions required if applied to all existing and future members.[10] In effect, to address these unfunded liabilities, the Government faces the choice as to who should bear the burden of these policy reforms - current employees (some of whom are close to retirement), future employees, current taxpayers, or taxpayers in the future.

88. The Government appears to be leaning in the direction of adjusting the retirement age, though no final decisions have been made. In July, legislation raised the mandatory retirement age for public service workers (excepting police officers, firefighters and Bermuda regiment soldiers) from 65 to 68. A Labour Advisory Committee Report (tabled by the Premier in Parliament) also recommended that legislation be introduced that would raise the retirement and pensionable age, over 10 years, from 65 to 70, with retirement age to be moved to 68 over a five-year period, with this to be reflected in amendments to the PSSF. Presently, only public sector workers have a mandatory 65 age requirement, though this is the generally accepted practice in the private sector. These proposals were debated in Parliament and received general support.

89. As suggested by the Panel in 2018, some mix of the actuaries' previous proposals will be necessary to address the unfunded liabilities of these public sector pension schemes. Our view is that the focus should be on increasing pensionable ages, gradually over time, while protecting the position of those close to retirement. This has a number of advantages: it provides an incentive to employees and employers to delay the actual date of retirement. and it reduces the necessity for large increases in contribution rates that would reduce real wages and increase labour costs, disincentivising job creation.

90. The continuing financial weakness of the CPF was also recognised in the pre-Budget Speech as a source of concern (reflecting less-than-buoyant contribution income). Although its financial assets are 11.5 times the annual value of the benefits paid in 2017-2018, an actuarial report on its 2017 financial position suggests that the CPF's assets would be exhausted by 2047 in a best-estimate scenario. The actuaries suggest alternative approaches to achieve long-term sustainability of the CPF, focusing principally on an increase in the pensionable age to 68 and a decade or so where the contribution rate would increase more rapidly than benefits.

91. The actuaries also recognised that the equity and sustainability of the CPF would be enhanced by basing contributions on income (rather than on a nominal flat rate), as suggested by the Premier in his 2018 Throne Speech. The need for action on reforms was also recognised by the Government when it explained why the recent 1.4% increase in benefits in January (backdated to August 2018) was not paired with an actuarially recommended increase in contributions of 3.9%. Although the Government has no legal obligation for the financing of the CPF, the Fund plays an important role in the broader social welfare fabric, and in practice it is unlikely that any future government would allow it not to meet its financial obligations. For that reason, its continuing financial vulnerabilities are a source of concern and should be an urgent agenda items in the coming months.

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10 Such a change would lead to an 88% pension payable for retirement at age 65 (compared to the 100% pension that would be received if the NRA is 65).

Fostering Sustainable Economic Growth

92. Bermuda's long-term economic growth prospects are limited by demographics, the risks associated with heavy reliance on just two sectors, financial services, particularly captive and international insurance business, and tourism, and with few other obvious sources of natural comparative advantage. As the panel noted last year, Bermuda is a small, remote, high-cost island with a domestic skills base that is currently insufficient to support new high-growth industries.

93. Bermuda's insurance sector has proved both resilient and flexible, supported by a well-regarded and responsive regulator; it has adapted its business model to incorporate the rapid growth of insurance-linked securities, and weathered a period of mergers and consolidations. The Bermuda Tourism Authority (BTA) has a clear and coherent long-term strategy, focused on higher value tourism and increasing volumes outside the peak summer season.

94. Both sectors are likely to remain central to Bermuda's economic prospects, and there is scope for growth. Government can support such growth by providing a supportive environment, both through the provision of infrastructure and appropriate regulation. For example, poor transport provision - both public and private - reduces Bermuda's attractiveness to foreign visitors. Smarter regulation, in particular of taxi and minibus services, and of rental electric vehicles, could help here at minimal or no cost to the public finances.

95. But economic diversification is also a priority and has formed a significant part of the platform on which the current PLP government was elected in 2017. Sectors favoured for diversification include fintech and "insurtech", with special emphasis on blockchain, digital and crypto currencies; technology; aviation and shipping; arbitration; biotech and life sciences; the blue economy; intellectual property; satellites and space; and nearshoring.

96. There has been a raft of recent legislation to promote fintech companies establishing on the island. Bermuda has been a world leader in this respect, with the Companies and Limited Liability Company (Initial Coin Offering) Amendment Act 2018 and the Virtual Currency Business Act 2018 among the first to provide a clear framework for cryptocurrency regulation. In September, the Digital Business Amendment Bill 2019 tweaked legislation approved last year for the Bermuda Monetary Authority's oversight of digital asset businesses and introduced new licensed business activities.

97. So far, these measures appear to have been moderately successful in attracting fintech companies to Bermuda, around 90 of which have now registered on the island. The premier told Parliament in September that 8 fintech companies had established offices, with 31 people working in the industry, 15 of them Bermudian, with "more to come." However, as the Panel argued last year, Bermuda must continue to be careful to enforce the highest international standards and to not be seen as encouraging new areas that could risk reputational damage by facilitating financial manipulation and fraud. This is particularly the case while the jurisdiction remains under scrutiny on tax, transparency and money laundering issues from the EU and CFATF.

98. In October, the Premier proposed an initiative whereby dollar backed stable coins (if licenced by the Bermuda Monetary Authority) would be accepted for payment of government taxes,

fees and services. We are uncertain as to how this will, in practice, be administered by the Office of the Tax Commissioner; there is a risk that this initiative could prove a distraction from the more immediate need to improve the efficiency and effectiveness of tax collection. More broadly, we are not convinced that this facility will be attractive to taxpayers; and, as noted above, there are significant reputational risks. We trust the Government will proceed with caution.

99. Bermuda is also seeking to leverage economic substance requirements to bring in more business. "Economic substance presents a unique opportunity to leverage our proximity to the financial centres on the eastern seaboard of the US to attract more asset managers to Bermuda" according to the Finance Minister. For example, the BDA is currently promoting Bermuda as an Atlantic digital hub for the interconnection of submarine cables, which would support the economic substance requirements for technology companies. Unlike the Pacific, which has three hubs, no such hub currently exists in the Atlantic.

100. As the Panel noted last year, the underdeveloped nature of domestic capital markets is also a concern in boosting growth. The Bermuda stock market is not a major source of new finance for domestically oriented companies, domestic lending by commercial banks has been weak, and there seems to be no domestic market for high risk start-up capital. It is possible that this inhibits potentially viable projects, outside the international business sector, from accessing finance. Also inhibiting access to finance is the absence of any requirement that businesses provide routine financial statements or accounts. For small businesses, this may hinder their access to capital. The absence of clear legal procedures for handling company failures in the non-financial sector may represent a further hindrance to business financing.

101. We note that only a relatively small share of private savings by Bermudian residents are invested domestically; this may inhibit domestic business' access to finance, and hence hamper business growth. One way to address this would be to set a target for a modest share of new pension savings to be allocated to domestic investment in viable projects. We recommend that the Government investigate how such a requirement could be made operational, without incurring unnecessary risk. We concur with the recommendations of the BermudaFirst group that Bermuda becomes more innovative in sourcing financing for future projects. Examples suggested include the use of privatisation, private-public partnerships and/or the issuance of Bermuda-dollar denominated bonds to Bermudians. Indeed, the Fortress Bermuda Infrastructure Fund has begun making investments in Bermuda.

102. Finally, as discussed in last year's Panel Report, the Government has followed through with its initiative concerning a "living wage" through the appointment of a Wages Commission that will make recommendations on a minimum hourly wage. This could boost purchasing power and hence aggregate demand in the economy, but it will be important that any minimum wage is set at a rate which does not inhibit job creation.

Climate Change and Energy Reform

103. The impact of Hurricane Humberto and the risks that surfaced from several other tropical storms in September highlighted Bermuda's vulnerability to climate change. The most

significant climate hazards for Bermuda are storms, rising sea levels and ocean change,[11] including the impacts to coral reef ecosystems; these hazards combine to leave the island with more vulnerability to large ocean swells, storm surge and flooding. In particular, it is noted that occurrences of coastal inundation that at present are deemed to be extreme events will be within the normal daily tidal range in as soon as 20 years, according to the latest science. Notable instances of recent coastal flooding have occurred in King's Square in the Town of St. George, a UNESCO World Heritage Site; and such events are expected to become more prevalent in the future. Preliminary studies suggest that coastal properties within 1 metre elevation above current mean sea level will flood far more frequently more frequently by the year 2050 than they do now.

104. This raises two principal concerns for Bermuda's economic and fiscal position: the cost to the Government of dealing with the economic and social impact of serious storms (including damage to key infrastructural assets, some of which are not insured) and the adverse impact that could be posed to key economic sectors (principally in the tourism sector). For instance, it has been estimated[12] that the total economic value of Bermuda's reef ecosystem is between $488 million and $1.1 billion a year, the bulk of which is accounted for by tourism. Currently responsibility for climate-related issues is at best ad hoc and fragmented across government departments with no single focus.

105. As noted last year, the Panel believes the Government should consider emulating other island economies in assigning responsibility and resources to a government department or joint committee for monitoring climate-related environmental indicators, providing risk assessments of threats emanating from climate change, and making proposals to mitigate the risks. The Government should also consider commissioning research on the medium to long-term impacts on Bermuda, the physical, economic and social risks, and policies needed to manage the risks associated with climate change.

106. Currently, less than 2% of Bermuda's electricity is produced with renewable resources, a small amount is produced by incinerating waste and the rest by burning imported foreign fuel. There are currently no legislated renewable energy targets. In July, Bermuda's electricity sector regulator (RA) released the island's first Integrated Resource Plan, which outlines the framework for Bermuda's energy requirements over the next 25 years. The regulator opted against natural gas as a principal generation fuel and in favour of offshore wind and more solar power.

107. Under the plan, within six years the island is scheduled to have a 60-megawatt offshore wind farm, 21MW of utility-scale solar photovoltaic supply and up to 30MW of "distributed generation," meaning residential and small scale solar. 85 per cent of the island's electricity will

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11 This is the principal result for Bermuda derived from a recent global study which allows for granular details on the impact of 11 climate hazards at any point on the globe, looking forward through 2095 under alternative scenarios on the pace of global mitigation efforts. See Camilo Mora et al, "Broad Threat to humanity from Cumulative Climate Hazards intensified by Greenhouse Gas Emissions," ***Nature Climate Change***, vol 8, pp. 1062-1071 (November 19, 2018). See also https://maps.esri.com/MoraLab/CumulativeChange/

12 Sarkis et al "Total Economic Value of Bermuda's Coral Reefs: A Summary" 2013 A Summary. ***Coral Reefs of the World***. 4. 10.1007/978-94-007-5965-7_15.

come from renewables by 2035, well in excess of the 38 per cent target of government energy policy. The capital investment needed to implement the plan is estimated at $273 million. It is anticipated that lower energy costs will reduce the cost of energy and doing business in Bermuda.

108. This would go a long way both towards reducing Bermuda's carbon emissions and reducing the need for fuel imports. We welcome the ambition of this agenda, but Bermuda's capacity to deliver such a programme of increased capital investment in renewable energy sources is untested: securing the financing, which will need to come from private sector sources, will be challenging, and it will be vital to ensure that investment is executed efficiently and economically. Moreover, the introduction of an element of competition in power generation will require significant changes to the current regulatory framework.

I. Conclusions and commendations

109. Bermuda, as a small open economy competing in a global marketplace, remains highly vulnerable to external events. These external risks – not merely financial but also broader economic, geopolitical and environmental - have not yet materialised, but have increased over the last year, and are unlikely to diminish in the medium term. Given the fiscal position, and the limited progress of the Government in acting on our previous recommendations, we are concerned that Bermuda will have little fiscal or macroeconomic policy space to address any crystallisation of these risks.

110. Over the longer term, the key concern for policy action remains domestic: the island's shrinking workforce and ageing population will put ever-increasing pressure on both taxes and spending. The issue is not whether action is needed, or even what actions are needed – there is a high degree of consensus, as expressed in both our reports and those of other independent bodies and indeed within Government – but when and how. Immigration reform, tax reforms and tax increases, immigration reform, and changes to the structure of health care and pensions are all required.

111. On tax reform, we regard 2019 as a year of missed opportunity, not just because of the further delay in meeting the target for budget balance, but because of the absence of significant tax reform along the lines of that proposed by the Tax Reform Commission or this Panel, as well as the de facto easing of the government's fiscal targets facilitated by the suspension of contributions to the Sinking Fund. On top of this, the failure of the Caroline Bay development resulted in a significant increase in government debt.

112. On the positive side, the Government has made significant progress in setting out a clear agenda for the reform of the financing of the healthcare system, exploring measures to address the underfunding of the pension system, both public and private, and appearing to recognise the need for major reforms to the immigration system. While implementation of reform will inevitably take time and be politically contentious, we commend the Government's willingness to address these complex and difficult long-term issues.

113. These are not just issues for Government, but for Bermuda and Bermudians as a whole. We call on all those with a stake in Bermuda's future to engage constructively, recognising the need for change; the status quo on all these issues - health, pensions and immigration - is not sustainable and would lead over time to much higher taxes on working Bermudians and deteriorating public services.

114. We make a number of suggestions and recommendations in this report. The key issues that need to be addressed without delay are as follows:

- **Fiscal targets:** In view of the recent change with regard to the treatment of the Sinking Fund, the Government needs to set out, clearly and transparently, its fiscal strategy and associated targets for the next few years. In our view, the government should set a new target for the fiscal balance of a surplus of at least $50 million, demonstrating a commitment to reducing the overall debt burden in nominal terms; and, consistent with the surplus target, a timescale for meeting the existing debt/revenue target of 80%. In our report last year, we proposed that 2028 would be an appropriate time frame.

- **Fiscal strategy and tax reform:** Meeting these fiscal targets will require significant revenue increases, given likely upward pressure on spending. We continue to believe that over the long term it would be appropriate to raise tax revenues significantly as a share of GDP, in line with other similar economies. We see no reason why Bermuda should not move from the existing payroll tax to a comprehensive progressive income tax, which would allow the proper taxation of capital income alongside labour income. We also think it necessary to increase revenues from multinational companies registered in Bermuda, whether by increasing registration fees or, over the medium to longer term, the introduction of a corporate income tax, which would also make a major contribution to improving Bermuda's position in international negotiations on tax harmonisation issues.

- **Diversification and sustainable growth:** The government's focus on fintech, if pursued prudently, is broadly appropriate, but considerable care needs to be taken given the potential reputational risks. More broadly, the underdeveloped nature of domestic capital markets, and the absence of a domestic market for start-up finance is a concern. We reaffirm our suggestions from last year relating to requirements for financial statements and bankruptcy procedures and some form of target for domestic investment – in viable projects – by the island's private and public pension schemes, which we understand is under review.

- **Reforming immigration policy:** Immigration is a difficult and charged political issue for any government, given Bermuda's difficult history; but this cannot be an excuse for inaction. The need for policy change to boost the population of working age and enable stronger economic growth is widely recognised across government, business and much of civil society. Bold action could help kickstart the business growth and job creation – for Bermudians as well as new arrivals – that Bermuda needs to address its immense demographic challenges.

- **Spending on health care:** The government has now set out an ambitious, radical and in our view broadly sensible programme of reforms. In particular, moving to a single-payer system is likely to be a precondition for successful cost control. Given the complexity of the issues, not to mention the political sensitivities, implementation will inevitably be a difficult and lengthy process. Healthcare represents a significant share of Bermuda's economy that, without action, will only increase. We commend the government's approach to date and urge them to continue on this path in order to sustainably respond to the health care challenges that an ageing population will confront in coming years.

- **Tackling unfunded pension liabilities:** As with healthcare, the government has clearly grasped the scale of the task and has a clear and, we believe, reasonably accurate view of the actions required. We urge a clear focus on raising both the pensionable age and the effective average age of retirement; this will both help address the issue of unfunded liabilities in both public sector and private pension schemes, and hence reduce the associated fiscal risk, and boost the effective size of the working age population and hence economic growth.

- **Government efficiency:** We are encouraged by the various initiatives that have been introduced to streamline and rationalise government services and public sector management and look forward to an assessment of their effects. We also recognise the appeal of a zero-based budgeting approach, but believe that focusing on specific areas where there are low-hanging fruit of potential savings is likely to be more successful in securing the budgetary resources needed to achieve fiscal sustainability. We also recommend strengthening the analytic capacity of the Government, most urgently in the Ministry of Finance, but also in respect of climate change.

- **Climate Change:** Bermuda cannot afford to ignore the risks to which it is exposed. We would encourage the Government to carry out an assessment of the economic and fiscal risks that climate change might pose to the island. Furthermore, responsibility for assessing such risks should be vested in a designated government agency, with clear lines of accountability.

115. The Government has, commendably, made major progress in setting out an agenda for reform of the health care financing system and, to a somewhat lesser extent, pensions. But this should not be an excuse for further delay in tax reform and immigration policy. The risk of a significant adverse shock, to which Bermuda remains extremely vulnerable, continues to rise. There is no time to waste.

The Panel looks forward to assessing progress made in a year's time.

Annex A: List of Meetings Held by the Panel (December 2-6, 2019)

The Honourable David Burt M.P., Premier
The Honourable Curtis Dickinson M.P., Minister of Finance
The Honourable Wayne Caines M.P, Minister of National Security
The Honourable Wayne Furbert M.P., Minister for the Cabinet Office
The Honourable Craig Cannonier M.P, Leader of the Opposition
Nick Kempe, Shadow Minister of Finance
Ministry of Finance
Ministry of Health
Office of the Tax Commission
Association of Bermuda Insurers and Reinsurers
Bermuda Bankers Association
Bermuda Health Council
Bermuda Monetary Authority
Bermuda Tourism Authority
Bermuda Chamber of Commerce
Bermuda Institute of Ocean Sciences
Nathan Kowalski (Economic Consultant)
Ronald Simmons, formerly Chairman, Tax Reform Commission
Robert Stubbs (Economic Consultant)

The Fiscal Responsibility Panel