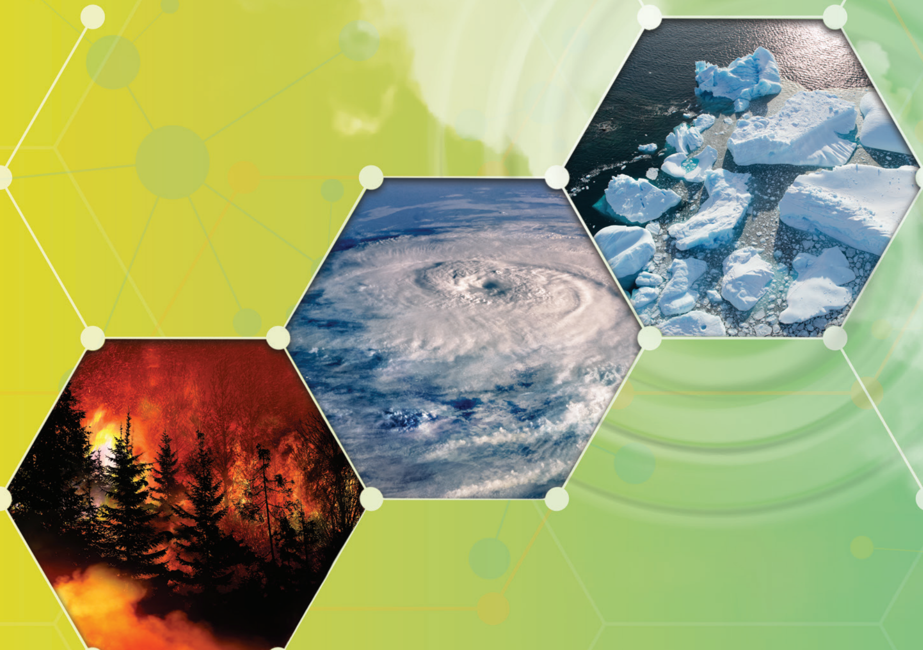
BERMUDA FISCAL RESPONSIBILITY PANEL

ANNUAL ASSESSMENT 2021



Jonathan Portes (Chair)
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December 2nd, 2021

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List of Acronyms

BEPS: Base Erosion and Profit Shifting

BDB: Bermuda Digital Bank

BHP: Bermuda Health Plan

BMA: Bermuda Monetary Authority

COP: Conference of the Parties of the UN Framework Convention on Climate Change

CPF: Contributory Pension Fund

CPI: Consumer Price Index

ERP: Economic Recovery Plan

GDP: Gross Domestic Product

GEHI: Government Employees' Health Insurance

IMF: International Monetary Fund

IPCC: Intergovernmental Panel on Climate Change

MNE: Multinational Enterprise

NDC: Nationally Determined Contribution

OECD: Organisation for Economic Cooperation and Development

PMO: Project Management Office

PSSF: Public Service Superannuation Fund

Quango: quasi-autonomous non-governmental organization

TRC: Tax Reform Commission

UHC: Universal Health Coverage

UN: United Nations

Executive Summary

This is the Panel's seventh annual report. We were pleased to be able to return to the Island in person this year, and we have had productive discussions with Ministers, officials and many others. We are grateful for their contributions, but all the judgements and recommendations are our own. Bermuda's economy is recovering from the worst effects of the pandemic, but while the international business sector has demonstrated remarkable resilience, tourism and associated services were hard hit, and recovery is very far from complete. Meanwhile, imported inflation is squeezing household incomes. And the impact on the Government's finances has been severe, with net debt now exceeding $3 billion, up more than a billion since the Panel began its work in 2015.

We therefore welcome the Government's renewed commitment to balance the budget by 2023–24, and we strongly endorse the Minister of Finance's clear commitment to remaining within the spending allocations for this year set out in the 2021 Budget. On present plans, the Government will remain within its new fiscal guardrails, for the ratios of gross and net debt to GDP, for the forecast period. However, the debt to revenue ratio, at over 300%, remains far above the target of 80%, and in addition there are significant contingent liabilities. Since, in our view, the debt to revenue target is the most important to long-term fiscal sustainability – and therefore to Bermuda's credibility with international financial markets – this remains a very serious concern.

Moreover, significant risks remain; in particular, that this very prolonged period of spending restraint is not sustainable, either politically or economically, or that revenues fail to recover as quickly as projected. We are not persuaded that it will be feasible in practice to finance the Government's ambitious commitments to economic and social development, as set out in the ERP and elsewhere, which will take some time to make a positive contribution to the fiscal position, without a significant modernisation and broadening of the tax base; nor that the current structure of the tax system is consistent with long-term fiscal sustainability. Over the medium term, the Government needs to boost revenues to reduce debt from its very elevated post-pandemic levels and to manage the considerable contingent liabilities.

Looking more broadly, Bermuda's most fundamental challenge is demographic; a shrinking workforce and an ageing population inevitably undermines the sustainability of the pension and health systems. Both systems require reform, but a growing working population would make a major contribution.

Pressing challenges include: the need to restart economic growth, in the traditional economic sector of tourism and related services and more broadly through further diversification; the need to modernise the tax system in the context of global discussions on minimum corporate tax rates; and of course climate change.

Our recommendations cover both fiscal issues and broader structural reforms needed to put the public finances on a more sustainable long term path:

Fiscal strategy: The Government's commitment to budget balance by fiscal year 2023–24, and the Minister's commitment to sticking to the 2021–22 spending allocations, are very welcome. However, we are concerned that there is no clear guide to policy thereafter. We therefore recommend that at the next Budget the Government commits to a further set of specific time-bound objectives for revenue and budget balance after 2023–24. Consistent with our previous reports, we recommend the Government target a budget surplus of $50 million per annum, to be achieved by fiscal year 2026–27, and continued thereafter, to pay down the debt and to demonstrate real progress towards meeting the debt-revenue target.

Tax strategy: The immediate challenge facing the Government is how to respond to international plans for a minimum effective rate of corporate income tax on the income of the largest global multinational enterprises. However, this could be an opportunity. The Government should aim to ensure that a significant share of the increased total taxes that will in any event fall on its international financial business sector accrues to Bermuda rather than elsewhere - while still preserving the attractiveness of the island as a location for international business. We remain of the view that Bermuda's tax system requires fundamental restructuring, and the Tax Reform Commission should be charged with developing a medium term tax strategy to increase tax revenues by moving toward a more progressive tax structure that taxes earnings from capital, including interest, dividend and rental income, as well as labour, and broadens the tax base while disincentivising behaviour that is damaging to health or the environment.

Expenditure Policy: Continued austerity may be challenging to achieve, particularly against the background of the ambitious policies set out in the Economic Recovery Plan (ERP), and the need to renew and modernise Bermuda's public infrastructure. Over the medium term, more fundamental reforms and efficiency measures are required. The Government also needs to exercise restraint in the provision of guarantees. The Government should make clear that guarantees will not normally be issued to back commercial projects, and that any guarantees will require a very clear and persuasive business case to show they are both essential to the viability of specific projects and represent an acceptable balance of risk and reward to the taxpayer.

The Economic Recovery Plan: We welcome the Government's commitment to the ERP. We are encouraged to note that significant progress has already been made with projects in several areas, particularly economic diversification, immigration, renewable energy and reducing medicine costs. However, implementing such a wide-ranging agenda is likely to be very challenging indeed. Delivery will require action across government in virtually every department, which may strain administrative capacity and resources.

Improving Bermudians' Access to Finance and Banking: There are several measures that should be pursued to improve Bermudians' access to finance and banking services. A Bermuda Digital Bank (BDB) could potentially make a major contribution. However, there are risks. If some or all of its capital were to come from government directly or indirectly, this would represent another risk to the long-term fiscal position. Any initial government start-up capital should be strictly limited, and there should be clear legislative and/or contractual provisions making clear that there is no scope for additional Government finance provided directly or indirectly, and that the BDB does not benefit from any Government guarantee, direct or implicit. Moreover, nothing should be allowed to jeopardise Bermuda's hard-won reputation as a well-regulated global financial centre. The BDB must be fully independent of government and subject to all the normal regulatory and supervisory requirements and procedures of the Bermuda Monetary Authority.

Immigration: We welcome the commitment to expand the resident population and to modernise immigration policy and administration. Significant progress has been made; but more needs to be done. Immigration offers an important counterweight to the negative impact of Bermuda's adverse demographics on its potential growth and wellbeing, and the long-run sustainability of the pension and health systems. The "Work from Bermuda" scheme is a welcome innovation, and could be broadened. In addition, much more could be done to streamline and modernise the work permit system, which would improve the business ecosystem. We also welcome the Government's commitment to improve the speed and efficiency of processing; this will require political, institutional and financial commitments across a number of dimensions: investment, speedy and efficient procurement processes; and perhaps most of all streamlining of the underlying processes.

Health: We broadly endorse the government's reform proposals, especially the introduction of the Bermuda Health Plan (BHP), which is planned to provide affordable, universal, health coverage. The incremental approach to implementation, starting with the public sector schemes, appears sensible and should help mitigate risks.

Pensions: Pension reform in Bermuda will, as elsewhere, require a combination of measures, including increased contributions (whether through raising contribution rates, the number of contributors, or some combination of the two), adjusted benefits, and higher retirement ages, reflecting increased longevity and working lives; all this is simply arithmetic. The alternative is that the funds will simply run out of money to pay pensions. We believe that the Government should, after due consultation with stakeholders, (i) substantially increase, in a phased manner, the retirement and pensionable age of most public service workers enrolled in the PSSF and CPF; (ii) increase the reference wage period to reflect a longer period before retirement; and (iii) increase contributions in an equitable manner. A package of measures along these lines would bring Bermuda more in line with comparator countries and would go a long way towards making the Bermudian pension structure more sustainable in the face of very severe financial and demographic challenges.

Climate Change: We welcome the establishment of the Climate Task Force working across government; it will be crucial to ensure that this function is adequately resourced going forward. In the light of the financial constraints facing Bermuda, the focus should be on resilience to climate change in terms of reducing Bermuda's vulnerability to extreme weather events, sustainable development, improving coastal and ocean management and leveraging the opportunities offered by Bermuda's natural mangrove and sea grass carbon sinks. We would encourage the Government to carry out an assessment of the physical, economic and fiscal risks that climate change might pose to the Island, and where necessary invest further in measures to improve its resilience. Bermuda's contribution to global emissions is minuscule and significant expenditure on reducing it further should not be a priority; only where investment is in any case taking place, or offers other significant benefits to Bermuda, should focus be on reducing the country's carbon footprint. Developing sources of renewable energy to replace imported fossil fuel, in line with the proposals in the ERP, does offer considerable economic benefits to the Island and should be pursued.

A. Introduction

1. This is the Panel's seventh annual report. Our remit, shown in Box 1 below, is set out by the Minister of Finance in our letters of appointment; it has been revised to incorporate the Government's latest fiscal targets, discussed in section F below.

2. Peter Heller, who had been a panel member since its inception in 2015, has now stepped down; he has been replaced by Victoria Perry, former Deputy Director, Fiscal Affairs Department, International Monetary Fund. The other two panel members continue: Jonathan Portes (Chair) and Marian Bell.

Box 1: Role of the Panel

The Panel is established to provide Bermuda's Parliament, Minister of Finance and the Financial Policy Council with an annual published assessment of the territory's fiscal strategy, focusing on progress in meeting the territory's medium term objectives for public spending, taxation, borrowing and debt reduction.

In its reports the Panel will therefore review:

1) Progress towards the Bermuda Government achieving a balanced budget by fiscal year 2023/24.
2) Compliance with the fiscal guardrails that Government has established — ratio of gross debt to GDP not to exceed 55%; ratio of net debt to GDP not to exceed 50%; and debt service to GDP not to exceed 3%.
3) Prospects for further progress towards meeting the longer-term aims of reducing debt and debt service to less than 80% and 10% of revenues, and for implementing the rule that net borrowing can only be considered to finance capital spending.

In making its assessment, the Panel will review the impact of the most recent Bermuda Government annual budget; the credibility of macro and fiscal assumptions underlying Government projections; and the risks that could affect progress in meeting the territory's fiscal goals.

The Panel may offer advice where needed on ways to refine these goals, and on adjustments to fiscal strategy and tax and spending policies needed to achieve them. If there are dissident views within the Panel, these will be included in its report.

3. Anthony Manders, the Financial Secretary, worked with the Panel since its inception. As our key contact at the Ministry of Finance, he was an invaluable support to the Panel. Both the present and former members of the Panel were deeply saddened to hear of his untimely death, and we join the Minister of Finance and the Premier in expressing our condolences to his family.

4. Last year, given the ongoing impact of the pandemic on both travel and working arrangements, our meetings were conducted remotely. However, we greatly value the face-to-face interaction with Bermuda's key stakeholders, inside and outside government, that we gain from our annual visits, and we were therefore pleased that we were again able to visit Bermuda this year. We had a full schedule of meetings and helpful discussions with Ministers and their officials, and thank particularly Cheryl Lister, Deborah Harris, Carol Martin and the other staff of the Ministry of Finance for their support. We would also like to thank the many others on the Island who have offered us information and advice (a complete list is in Annex A). However, the report's judgements and recommendations reflect our own independent views. Our report is, as with all our reports to date, unanimous.

5. The report is structured as follows. Section B summarises our key findings and recommendations from last year; section C sets out economic and fiscal developments in Bermuda since our last report, and describes the Government's Economic Recovery Plan; section D examines external developments; and section E focuses in detail on international corporate taxation issues. Looking forward, section F discusses the implications for the public finances, and in particular sets out our judgement of the Government's progress towards meeting the fiscal rules and targets set out above, and section G sets out our recommendations. Finally, Section H summarises our conclusions and sets out our key recommendations.

B. Key findings of the 2020 Report

6. Our 2020 Report was the first to be conducted against the background of the ongoing COVID–19 pandemic. We praised the Government for its prompt and effective actions to protect the population and mitigate the economic consequences for businesses and livelihoods. It successfully addressed the first wave, in turn allowing the economy to reopen while protecting the population. The Government's refinancing operation, undertaken in August 2020, which we strongly recommended and endorsed, ensured that the Government remained in a position to finance its deficit without further recourse to the markets in the short-term, substantially mitigating near-term risks.

7. However, we also noted that the fiscal and debt impacts were considerable. Our estimates implied that the Government faced a fiscal gap of at least $50 million if the budget was to be balanced by 2023–24. We recommended a package of measures to preserve the gains that had been made, to shore up the public finances, and to build confidence in the Government's fiscal plans and resilience for the future.

8. Our specific recommendations were that the Government aim to at least restore revenues to the pre-COVID–19 level of $1,110 million by 2022–23, with a further significant increase in 2023–24 to meet the balanced budget target; and that beyond budget balance in 2023–24, the Government should target a budget surplus of $50 million per annum, to be achieved by fiscal year 2026–27, and continued thereafter. In order to achieve this, we recommended the introduction of:

- **(i)** a withholding tax on dividend and interest income;
- **(ii)** an annual rental tax on owners of large properties and multiple units (thus exempting all but high earners);
- **(iii)** an increase in taxes on sugar and other unhealthy products; and
- **(iv)** a carbon tax.

9. Beyond fiscal policy, we also set out a far-reaching and comprehensive package of measures, covering public expenditure control and reform, pensions, health care, immigration, climate change, and economic diversification. We noted that these proposals summarised and built on the work of a wide variety of Bermudian stakeholders, in government, opposition, business and civil society over a period of many years. And we noted that, while difficult decisions were needed, the crisis, and the Government's renewed electoral mandate, offered an opportunity to reconsider important aspects of the public finances, society, and the economy.

C. Developments since the 2020 report

10. The Bermuda economy is estimated to have shrunk by nearly 7% in 2020, rather less than earlier feared, as economic activity was restricted by the pandemic. The decline was led by a slump in tourism, with consequent knock-on impacts on transport, retail and hospitality. The output of the accommodation and food service sector, usually around 4% of GDP, fell nearly 70% as total air and cruise arrivals fell by 84.4% and 98.3% respectively and visitor spending by 86.6%. Construction activity was also much reduced, but the largest sector, which accounts for around a quarter of the economy, international business, particularly insurance, was resilient, growing by 1%. Although, as the economy opened up, GDP (not seasonally adjusted) was 13.6% higher than a year earlier in the second quarter of 2021, expenditure, in constant prices, was still around 6% below its level two years previously. The largest contributor to the rise in the year to the second quarter was household spending, up 12.3% in real terms. Spending on goods, especially durable goods, up by 51.0% following a 32.8% decline in the previous 12 month period, was particularly strong, led by purchases of motor vehicles. Together with positive annual growth in monthly retail sales volumes through the first half, this could be indicative of some underlying strength in consumer demand, although on Island sales fell back in July as year on year comparisons became more challenging.

11. Meanwhile, government consumption fell 5.6% and Gross Capital Formation grew 34.6% in the year to the second quarter as spending on machinery and equipment rose 46.0 % and construction 25.6%, reflecting the completion of the St Regis resort and the construction of some new residential units. The trade surplus increased further, by 18.1%. as export growth outstripped that of imports, reflecting returning visitors and exports of professional services.

12. Bermuda has continued to battle waves of COVID–19 through 2021, including a fourth wave of significant community transmission believed to be of the Delta variant this autumn, requiring a scaling back of Bermuda's hitherto world leading testing regime and a pause in genome sequencing. The hospital risked becoming overwhelmed and COVID–19 deaths increased markedly, reaching over 100, or about 160 per 100,000, since the start of the pandemic. Although, in the context of a high vaccination rate, a total shutdown did not have to be implemented, recurring COVID waves will nevertheless have resulted in a loss of output due to curfews, restrictions on activity and employees isolating. It has also impacted Bermuda's attractiveness as a destination for tourists, business visitors and digital nomads. Although air visitor numbers picked up through the summer and cruise ships resumed Bermuda visits in June, more recent visitor numbers, particularly from the US, have disappointed. Industrial action including a two day labour stoppage at the end of August, arising from disputes over new legislation, will have further dampened output.

13. The prospects for GDP growth in the remainder of the year thus look poor, but year on year comparisons will be flattered by the depressed base year. The cautious central budget projection for economic growth of approximately 3.5%, with a modest rebound across all major domestic and international business sectors, but with a conservative view of the recovery of tourism and air travel, should be achieved.

14. Consumer Price Inflation slowed in 2020 when prices were virtually flat year on year, but has picked up since to stand at 1.6 % in August, and is likely to rise further, reflecting global trends. The Transport and Foreign Travel sector continued to be the largest contributor to inflation reflecting the rising cost of airfares and premium fuels.

15. Bermuda ran a $922 million surplus on the current account of its Balance of Payments in 2020, further increasing in the first half of 2021, primarily reflecting an improving primary income balance as net investment income increased due to reinvested earnings and net employee compensation rose, as payments to non-residents fell.

16. Bermuda therefore appears to be experiencing a two-speed recovery. The international business sector was resilient during the pandemic, and appears to be continuing to grow. By contrast, tourism and associated services (including retail and hospitality) were hard hit, and recovery is very far from complete. Meanwhile, imported inflation (a global phenomenon) is squeezing household incomes.

Fiscal outturn for 2020–21

17. At the time of the 2021–22 budget presentation in February, the overall fiscal deficit for 2020–21 was expected to be $245.5 million, over 12 times the original $19.8 million deficit forecast in the 2020 Budget and over 7 times that of the previous year. It was, however, somewhat less than the $294 million deficit anticipated at the time of our last report in December 2020. Revenue of $960.6 million fell $161.6 million (14.4%) short of the $1.1 billion originally budgeted, mainly as a result of the impact of the COVID–19 pandemic on many of the Government's revenue streams, especially payroll tax, customs duty, and tourism-related taxes and levies. However, this was an improvement on the $914.1 million estimated in the Pre-Budget Report, reflecting the relative resilience of the international business sector and hence associated tax revenues.

18. There was also an estimated $127.2 million of unbudgeted COVID–19–related expenditure in 2020–21. This included unemployment benefits, PPE, COVID–19 testing, quarantine facilities and vaccination services, grants for the BEDC Business Sustainability and Continuity Funding Programme, and funding for the Bermuda Airport Authority to honour the airport minimum revenue guarantee with Skyport.

19. Partially offsetting this, the Government's normal operating expenses were $55.6 million (5.9%) lower than the original $935.6 million budget, at $880.0 million. This was the result of a number of cost-saving initiatives through the year, including a freeze on the funding of vacant posts not required to address COVID–19 or protect Bermuda's national interests, a ban on non-essential government travel; reductions in discretionary spending; and negotiations with the unions leading to temporary payroll and government employee overhead savings, including a temporary suspension of matching pension contributions. As a result, the rise in total current expenditure for 2020–21 was limited to $71.6 million (7.7%) above budget, at $1.0 billion.

20. The original capital expenditure budget for 2020–21 was $85.0 million. Although the capital budget was subsequently increased to $93.0 million to support economic recovery and provide employment for Bermudians, due to delays relating to COVID–19, capital expenditure for 2020–21 was expected to be just $70.1 million, $14.9 million (17.5%) lower than originally budgeted.

21. Following the August 2020 borrowing and debt refinancing exercise, gross debt stood at $3.35 billion as of 31 March 2021, up from $2.69 billion the previous year. While the Government's average borrowing costs were reduced by the refinancing, debt service costs for 2020–21 were nevertheless forecast to be $128.8 million, $7.4 million above the original estimate, as gross debt rose. Taking into account the Sinking Fund balance of approximately $306.5 million, which had been boosted by the proceeds of the debt raising, net debt was $3.044 billion.[1]

[1] The debt refinancing resulted in a significant increase in net debt, as outstanding debt originally issued at higher coupon rates, and therefore trading above par, was refinanced at current market rates.

22. Net debt has therefore risen by more than $1 billion since 2015, when the Panel was created. This rise is the result not just of the pandemic, but also very slow progress on modernising and reforming the tax system to raise the revenue share of GDP and ensure a sustainable fiscal position; it also reflects the large increase in debt resulting from the realisation of the Government's contingent liability on the Caroline Bay development at Morgan's Point.

The Economic Recovery Plan

23. Alongside the immediate measures taken to deal with the economic consequences of the pandemic, Bermuda has developed an Economic Recovery Plan (ERP), to improve GDP growth, economic diversification and the public finances. The Plan will work in parallel with, and to some extent encompass, immigration, health, education and social reform, assessing possible areas of tax and pension reform; as well as additional government initiatives to support the vibrancy of Bermuda's international business sector. Presenting the plan, the Minister of Finance described the pandemic "as a once-in-a-generation opportunity to address diversity and inclusion, improve access to and participation in the economy, enact fiscal reform, and focus on climate change. We must focus and invest in key infrastructure projects intended to stimulate growth, enhance climate resilience and equip our economy for the future of working in an accelerated digital economy". The ERP's core principles and the 31 priority measures, grouped around seven themes, are set out in Box 2.

24. The ERP argues that international comparisons suggest successful implementation of the plan should deliver economic growth of 1.3 – 1.5 percentage points per annum above the baseline 0.8% historic trend growth rate – a considerable boost if it can be achieved. This additional growth is expected to begin to materialise from fiscal year 2023–24 onwards.

25. A full assessment of the ERP is beyond the scope of the Panel's remit or capacity. Nevertheless, the Panel notes that the principles underpinning the ERP are very much consistent with those outlined by the Panel in its previous reports, although we would argue that climate resilience should be included. We welcome the scope and ambition of the policy proposals outlined in the plan, and the speed with which some of the measures are being implemented. Our specific recommendations are discussed in section G below.

D. External developments and risks

26. Global prospects remain clouded by the COVID-19 pandemic. While Western countries have good access to vaccines, the reluctance of some segments of their populations to be vaccinated, waning immunity amongst the vaccinated, poor vaccine coverage in less developed nations, the emergence of new, more easily transmissible variants, such as Delta and Omicron, and the resumption of international travel have prevented a full return to normal activity. Recurring waves of COVID-19 continue to present a direct and, through the impact on global activity and tourism, indirect threat to Bermuda.

27. Despite a reasonably rapid recovery, in most developed countries output and employment remained below pre-pandemic levels in the second quarter of 2021. But even an incomplete bounce back will see rapid rates of growth recorded this year. Both the IMF and the OECD expect world growth in the region of 5½ to 6% this year, with the US growing by around 6%, following a 3.4% decline in 2020. Next year, somewhat more moderate growth in the region of 5% is anticipated as the more advanced economies return to trend.

Box 2: The Economic Recovery Plan

Principles

1) **Combatting COVID–19 as a priority:** no economic plan should jeopardise the safety of Bermudians or undermine their sacrifices.
2) **Reducing the cost of living:** reform initiatives must be targeted at reducing the cost of living for all Bermudians.
3) **Fairness and equity:** policies need to ensure that growth is enjoyed by all segments of society, privileging those most in need.
4) **Financial viability:** any funding being used to support these policies needs to be directed only to firms and industries which have long-term viability in Bermuda.
5) **Fiscal prudence:** fiscal discipline needs to be exercised in managing the Government's finances and borrowing should not mortgage the future of younger generations of Bermudians.
6) **Timeliness:** bold and decisive action needs to be taken now. Where possible, there should be accelerated implementation of highest priority initiatives to quickly improve Bermuda's economic situation.

Themes

From an initial list of 81 proposals, the Government identified 31 priority initiatives, broadly grouped into seven core themes:

1) **Diversifying Bermuda's economy** through the growth of new industries and by stimulating existing ones, with co-investment from the private sector including Bermudians to enable a new generation of investors. Projects include medical tourism, vertical farming, an online SME marketplace, residential development in Economic Empowerment Zones, a casino industry, sub-sea communications, and the Space Strategy.
2) Making **financial markets** work better for businesses and consumers. This will include measures to lower mortgage interest rates by increased competition in the banking sector and working with local banks to provide security; continued support, through the Bermuda Economic Development Corporation (BEDC), for small businesses; creation of a National Digital Bank to allow stalled industries to commence, **creating** jobs and economic growth, while connecting Bermudians to global digital payments.
3) Building critical new **infrastructure** or enhancing existing infrastructure, such as completing a shoreside facility for fishing, upgrading water and waste management, building more affordable homes, implementing the North-East Hamilton Development Plan, developing an electric vehicle charging infrastructure and a Green Energy Fund for solar installations.
4) Expanding the resident **population**, for example through the introduction of the Economic Investment Certificate, regularising the position of long-term residents, and making it easier for Bermudians born overseas to return home by amending the requirement for Bermudian parents to prove domicile for children born overseas;
5) Introducing **labour market** reforms and social development measures to deliver skills, employment and economic security. Measures include execution of a national jobs strategy and youth employment strategy, establishing national unemployment insurance, and implementing minimum and living wage legislation;
6) Reforming the delivery of **healthcare** through the introduction of the Bermuda Health Plan (BHP), an affordable universal healthcare system, and by reducing the cost of medicines to consumers by establishing a national drug formulary that will set maximum pricing for commonly prescribed medications.
7) Developing supportive **legal and regulatory frameworks** such as: an energy regulatory sandbox that will encourage developers of new renewable energy technology to test their products in Bermuda; digital/FinTech; a marine economic development plan to provide sustainable fisheries; a regulatory regime licensing all activities involved, directly or ancillary, to the cultivation, import, export, production, sale, supply, use or transport of cannabis or medicinal cannabis.

28. Macroeconomic policy stimulus and the release of pent up demand, combined with supply bottlenecks, has led inflation to rise markedly in some countries, including in the US. Rising prices will affect Bermuda, which is heavily reliant on imported final and intermediate goods and commodities. The extent of the monetary policy response to rising inflation will depend on whether it is viewed as a temporary shock or whether rising inflation expectations and wage demands lead to a more entrenched increase. In November, the US Federal Reserve announced that it will start tapering its bond purchases, ceasing altogether by the middle of 2022, while the UK's Bank of England signalled that policy rates would rise. As inflation expectations rose, benchmark 10 year US Treasury yields rose sharply from 0.9% at the end of last year to peak at 1.75% at the end of March, before easing back to approximately 1.5% in late November.

29. Given the scale of Bermuda's debt, the possibility of a large, sustained rise in global interest rates remains one of the most serious risks facing Bermuda. The Government should be alive to opportunities to refinance debt falling due in the next few years while bond yields are still close to historic lows and spreads on Bermudian debt relative to Treasuries remain low.

30. Climate change is increasingly acknowledged to be a major and growing threat, in the light of a further increase in extreme weather events over the last year, a new report by the Intergovernmental Panel on Climate Change (IPCC)[2] and the COP26 climate conference. Although the Glasgow conference agreed in principle to limit global warming, it fell short of agreeing sufficient specific measures to bring this about, and did not include enforcement mechanisms. Much will now depend on the response of individual nations in limiting their Nationally Determined Contributions (NDCs) ahead of next year's COP26.

31. Bermuda is particularly vulnerable to climate change, to movement of the Gulf Stream, increasing frequency and intensity of storms and hurricanes, storm surges and rising sea level, given its geographical position and relatively low-lying land. Rising ocean temperatures and acidification will affect its coral reefs, biodiversity, fishing and tourism. The IPCC found that, due to past and future greenhouse gas emissions, many climate changes are now irreversible. It is now virtually certain that the global mean sea level, which increased by 0.20 metres between 1901 and 2018, will continue to rise over the rest of the 21st century due to continuing deep ocean warming and ice sheet melt. The likely rise by 2100 relative to 1995–2014 will be at least 0.28–0.55 metres and could be as high as 1.01 metres. Global mean sea level rise above the likely range – approaching 2 metres by 2100 and 5 metres by 2150 under a very high emissions scenario – cannot be ruled out due to deep uncertainty in ice sheet processes. Due to relative sea level rise, extreme sea level events that occurred once per century in the recent past are projected to occur at least annually at more than half the world's tide gauge locations by 2100. Relative sea level rise contributes to increases in the frequency and severity of coastal flooding in low-lying areas and to coastal erosion. In Bermuda, a rise in sea level and ocean change will create the risk of ocean swell and storm surges that could inundate key infrastructure and heritage sites (e.g. the airport and St George's) on a regular basis. Occurrences of coastal inundation that at present are deemed to be extreme events will be within the normal daily tidal range in as little as 20 years.

32. Also of concern to Bermuda and its ocean economy, ocean warming ranging from 2–4 to 4–8 times the 1971–2018 change is likely over the rest of the 21st century, while upper ocean stratification, ocean acidification and ocean deoxygenation will continue to increase at rates depen-

[2] IPCC, 2021: Summary for Policymakers. In: Climate Change 2021: The Physical Science Basis. Contribution of Working Group I to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change

dent on future greenhouse gas emissions. Open ocean surface pH as low (acid) as in recent decades was unusual over the last 2 million years. Meanwhile, both the proportion of intense tropical cyclones (categories 4–5) and the peak wind speeds of the most intense tropical cyclones are projected to increase at a global level.

33. Bermuda's insurance and reinsurance sector is exposed to climate risk, but appears sufficiently well capitalised to deal with increasing extreme weather and natural catastrophe events, benefiting from increased investment returns, higher premiums and increased insurance penetration. While this could change in the event of a series of adverse events, Bermuda's financial regulators are closely monitoring these risks.

34. Meanwhile the insurance industry in Bermuda, a global centre with many years' experience of managing climate related risk, is extremely well placed to take advantage of increasing interest in climate related products such as climate risk finance.

35. Broader geopolitical risks remain, including tensions between China and the US, and the rise of authoritarian and nationalist political movements in the US and parts of Europe. While Bermuda is relatively insulated from the direct impacts of these developments, it cannot expect to be immune.

E. International discussions on corporate tax

Background

36. Bermuda faces a pressing challenge: international developments on corporate taxation potentially pose a threat to Bermuda's business model, but may also present an opportunity. The Government intends to relaunch the Tax Reform Commission (TRC) to address these global changes in the international tax architecture, though at the time of our visit to Bermuda the TRC had not yet officially been reconstituted.

37. The past decade has seen major shifts in the international taxation landscape, both in terms of the taxation environment for cross border business, and of the environment for the provision of offshore banking services to individuals, trusts and companies. The former was embodied in the G20/OECD 2015 "BEPS" project ("BEPS 1.0"), with minimum standards and recommended actions, and also through the adoption of certain standards by the EU. It should be noted, in the context of what follows, that the original BEPS project was explicitly not intended to change the allocation of taxing rights across countries, nor to reduce or eliminate "non-harmful" tax competition. Rather, BEPS 1.0 was aimed at closing "loopholes" in the traditional architecture that permitted legal tax minimisation by multinational enterprises (MNEs) that was deemed contrary to the purposes and spirit of the architecture—for example by permitting the creation of "stateless" income that was taxed nowhere.

38. Changes to the offshore banking environment are embodied in the work of the Global Forum for Tax Transparency and Exchange of Information, the rules of which now necessitate much greater transparency in account identities, and demand automatic exchange of information with authorities of other tax jurisdictions regarding such accounts. While the Forum's rules are only enforced (at this point) through peer review reporting, categorisation as "non" or "partially" compliant can have very negative effects on jurisdictions.

39. These various changes have already had an impact on aspects of Bermuda's finance and international business environment, laws and regulations as the Government has moved to comply with these new rules. In particular, changes to the "economic substance" requirements to comply with new standards were undertaken several years ago. Given Bermuda's favourable climate for international financial business—particularly the (re)insurance industry—with local supporting services and a sophisticated and efficient regulatory environment – these changes do not appear to have undermined Bermuda's attractiveness, nor the revenues received directly and indirectly from the international financial sector.

40. Now, however, further and even more radical proposed changes to the international tax architecture are in process, under the aegis of the G20/Inclusive Framework on BEPS (the "Inclusive Framework") of which Bermuda is a member. Some of these changes—sometimes referred to as "BEPS 2.0"–will likely lead to the need for still more adjustments on Bermuda's part. Yet if handled well, Bermuda could stand to benefit fiscally from these changes.

The G20/Inclusive Framework as of November 2021

41. Several years of negotiation and highly technical work, beginning in 2017, by OECD tax staff and country and jurisdiction members of the 139-member Inclusive Framework resulted in "blueprints" for fundamental changes in the long-standing international corporate tax architecture—changes that were deemed necessary as a result of the "digitalisation" of the global economy. Detailed blueprints were published in October 2020 covering two aspects of these changes in two separate "pillars". Technical work, negotiation, and stakeholder commentary and input have continued at a hectic pace since then, with a new version of both pillars made public on July 1, 2021, following on from an agreement among the G7 countries in June. At the end of October, a final version was agreed by the G20, and work in the OECD and Inclusive Framework is underway to produce detailed rules for implementation of the pillars, with the aim of completing this before year end.[3]

42. *Pillar One* would promulgate rules for addressing nexus and profit allocation challenges arising from the ability of major MNEs to engage in business—in lay terms as opposed to technical tax law terms—in jurisdictions where they have no traditional physical presence. Pillar One, through its primary mechanism "Amount A," is radical in two respects: first in allowing a profit tax nexus in such "market" jurisdictions, as opposed only to jurisdictions where production is traditionally deemed to take place; and second, in allocating some portion of a covered MNEs profits to such jurisdictions using a formula applied to the MNEs universal/world profits. These provisions as presently proposed would apply to a rather limited set of very large companies, multinational businesses with global annual turnover exceeding EUR 20 billion and profitability above a 10% margin. This would largely result in shifting of some corporate tax revenues among the most advanced economies—as opposed to expanding the tax base significantly. Further, businesses in the extractive and regulated financial services sectors—notably including the insurance industry—would be excluded from Amount A. Pillar One would have little if any impact on Bermuda, and therefore is not discussed further in this report.

[3] It should be noted that all rules arising under the new framework would have to be adopted by individual countries in order to have legal effect—and that agreement in the Inclusive Framework cannot guarantee that such rules will ultimately be legislated. For example, the US Congress is discussing the adoption of tax changes as proposed by the Biden administration—some of which would implement aspects of the same goals as those under consideration in the Inclusive Framework.

43. *Pillar Two*, on the other hand, could in theory have a very significant impact on Bermuda's economic model. Pillar Two is intended to create an agreed "global minimum effective tax," at a rate of 15%, with the aim of ensuring that all MNE profits are taxed somewhere by some country at that effective rate, or higher. The idea is to eliminate the incentives for MNEs to shift taxable profits to low or no tax jurisdictions, which do include Bermuda. Low tax jurisdictions are the segment projected to lose tax base and revenues from this minimum tax approach. While Bermuda has long imposed no regular corporate income tax on either domestic or international businesses, approximately 7% of projected 2021/22 government revenues are derived from fees imposed on the international business sector. More important though is the question of whether this change in the global architecture will cause the current international business and finance sector in Bermuda to shrink, or at least to reduce or eliminate potential growth—with an accompanying loss of employment not only in the sector but in all of the supporting services and spillovers to the local economy. On the fiscal side, it is estimated that approximately half of all payroll tax revenues derive directly or indirectly from the international business sector.

44. Finance Minister Dickinson stated in his Budget Statement 2021–2022 that, "...the most pressing threat to Bermuda's international business sector, and therefore to Bermuda's economy, remains the [OECD's] focus on base erosion and profit shifting, and the [EU's] list of non-cooperative tax jurisdictions." On July 16, he noted that the Tax Reform Commission was being reconstituted, but that it was anticipated that most of its work would not take place until after the October release of technical details on the BEPS Pillars. He noted then that "Pillar Two will be central to our considerations," and that "Bermuda [is] an active participant in the ongoing work of the Inclusive Framework..."

Implications for Bermuda

45. Critical to the impact of Pillar Two on Bermuda will be how the international business/finance community balances the many benefits of its existing sophisticated infrastructure in the country against the potential loss of global tax benefits from imposition of corporate profits tax on currently untaxed profits deemed arising in Bermuda. While the exact shape of certain technical aspects of the proposed Pillar Two are not yet clear, it is now clear that the insurance industry, and other financial businesses including related hedge funds, are within the scope of affected multinational enterprises. It is notable, and a positive sign, that the 2017 US tax reform act, which itself imposed a minimum tax on residual foreign profits of US multinational enterprises, did not appear to have a negative impact on Bermuda from the US owned parts of the Bermuda insurance industry. Importantly, Bermuda's business model, despite its lack of a corporate income tax, is indeed very different from that of jurisdictions that have created themselves as offshore havens and tax planning investment hubs, with lack of any domestic business substance. By contrast, Bermuda has constituted itself as one of the major global centres for the insurance and reinsurance industry.

46. The Bermuda Government is presently deeply engaged with both the Inclusive Framework technical working groups, and in dialogue with the local international business sector, in an effort to develop a viable response to Pillar Two. The Government is publicly committed to a collaborative approach with the sector in this regard. This is particularly needed—as well as generally being a productive approach—given the tax stability agreement to 2035 that is in place with the international business sector.

47. Essentially, Pillar Two is intended to result in the MNEs within its scope paying net corporate profit taxes of at least 15% somewhere. As a stylised example, if such profits were generated in Bermuda, but not taxed at all there, tax in the parent jurisdiction would be imposed to top up the effective tax to that rate. Thus the direct fiscal benefit would accrue to the US, the UK, or other MNE headquarters jurisdiction. While, again, details are being developed currently, it is possible that the international business levy in Bermuda might count in calculating the minimum effective rate. But this would be nowhere near 15%.

48. Bermuda likely will therefore face a choice: retain its current tax regime, but see inevitably higher taxes on global profits that are generated in Bermuda accrue to other jurisdictions; or, rather, alter its tax regime so as to increase the local tax take—while not creating negative incentives for the sector to continue to centre its business in Bermuda. The latter is clearly preferable, although implementation will be complex and will require careful and detailed consultation and engagement with the international business sector, in particular, the (re)insurance sector. Given this complexity, there are as yet no estimates of potential revenue. However, if handled appropriately and proactively, the advent of the global minimum tax could prove a positive for Bermuda.

F. Fiscal and Debt Prospects

49. The COVID–19 crisis has left a permanent scar on the Government's fiscal position. In our 2020 report, we noted the Government's objective of eliminating the deficit by 2023–24, but we cautioned that, without additional action to reduce debt over the medium to long term, this strategy entailed significant risks. We noted that the Government's cumulative borrowing requirement (ignoring short-term credit facilities) over the second half of 2020–21 and the subsequent two financial years would be financed from the Sinking Fund.

50. However, we also noted that the Government will need to refinance a large amount of maturing debt, in particular the bonds maturing in December 2022 and January 2023, totalling almost $500 million, at a time when the Sinking Fund will be substantially depleted.[4] Bermuda thus remains at the mercy of the credit rating agencies and financial markets, themselves driven by unpredictable global events. As we concluded last year:

"Bermuda is gambling that international financial markets remain willing to lend freely at low interest rates; in a pessimistic scenario, it is heading for a fiscal cliff. Given the uncertainties, it is obviously not possible to attach specific probabilities to these scenarios. And even if recovery in the short term is stronger than we or the Government currently assume, this does not significantly alter the medium-term picture, in particular the need to refinance a large amount of debt by early 2023 at the latest. Our view therefore is that a failure to take early action involves an unacceptable level of risk."

[4] The Government had an option to refinance the December 2022 bond early (as we noted in our last report) but decided that the available terms were insufficiently attractive.

Box 3: Government Debt as of 31 March 2021				
	MATURITY	RATE	31 March 2021	Interest
140M SENIOR NOTES (multiple purchasers)	04/12/2022	5.730%	140,000,000	8,022,000.000
144Reg/S Bond	03/01/2023	4.138%	353,905,000	14,644,588.900
Local Bond	16/12/2023	4.750%	50,000,000	2,375,000.000
144Reg/S Bond	06/02/2024	4.854%	402,203,000	19,522,933.620
144Reg/S Bond	25/01/2027	3.717%	604,624,000	22,473,874.080
144Reg/S Bond	15/02/2029	4.750%	449,268,000	21,340,230.000
New 10-Year	20/08/2030	2.375%	675,000,000	16,031,250.000
New 30-Year	20/08/2050	3.375%	675,000,000	22,781,250.000
Total			**3,350,000,000**	**127,191,127**
				3.80%
Sinking Fund			306,473,000	
Net Debt			**3,043,527,000**	

51. Developments since then have not fundamentally changed the underlying picture. On the positive side, the fiscal outturn for 2020–21 is slightly better than projected at the time of our last report, with revenues recovering somewhat quicker than forecast, and an underspend on capital expenditure. The 2021 Budget forecast that the deficit will fall from $245 million in 2020–21, to $125 million in 2021–22, $41 million in 2022–23, with a small surplus in 2023–24.

52. This means that the cumulative deficit over the three years to 2022–23 is now forecast to be $410 million rather than the $470 million we expected then. The forecast balance for the Sinking Fund in April 2022 is $180 million, meaning a substantial amount of the cash raised in the August 2020 financing exercise will remain, even after the very elevated deficits of 2020–21 and 2021–22.

53. However, there are significant risks attached to these projections. The Budget was fixed before the resurgence of the pandemic in Bermuda in September. Actual revenue and spending data from the year so far presents a mixed picture: revenues overall look to be on track, with strong payroll tax revenue offsetting shortfalls elsewhere, particularly in tourism-related revenues. But spending pressures are already emerging, with significant, albeit unsurprising, overspends on health-related expenditures, while the allocation for unemployment benefits for the full year has already largely been exhausted.

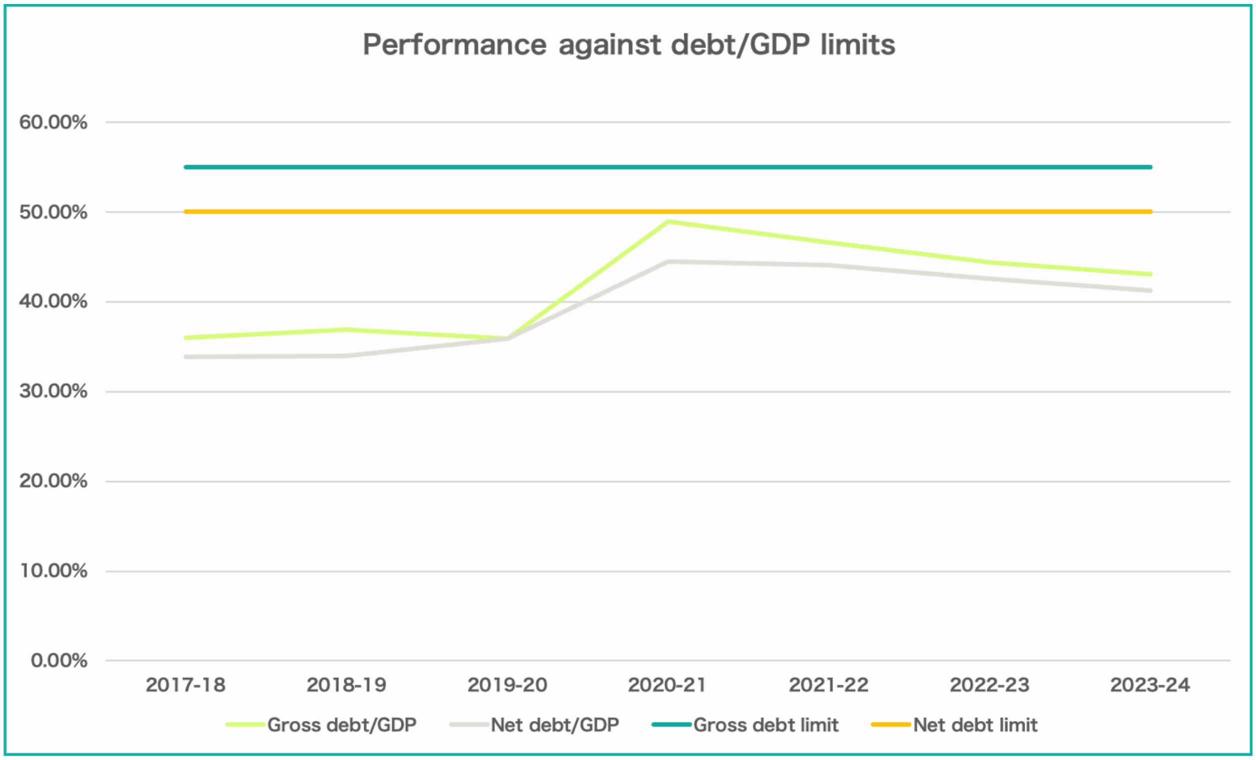
54. The Minister of Finance has made strong public commitments both to the importance of expenditure control overall, and to his personal commitment to ensuring that the Budget totals are delivered; this is likely to require savings measures to be implemented across the board to offset pandemic-level pressures. This commitment is welcome. We were also assured that there was no intention to repeat the earlier suspension of government pension contributions, which would be inappropriate and unsustainable from both an economic and an accounting perspective.

55. Beyond the current year, there are significant question marks over the fiscal path set out above, for 2022–23 and beyond. On the spending side, the Budget assumes that current spending only grows by 1% per year. This implies that spending in 2023–24 would be similar to that in 2014–15, in cash terms. It is unclear whether this path will be sustainable in practice: significant spending pressures are likely to emerge over this period, and a number of the measures the Government has adopted – in particular, the freeze on civil service recruitment - are unlikely to be either sensible or desirable for such a long period. The extensive and ambitious list of commitments detailed in the ERP will inevitably require spending increases in some areas.

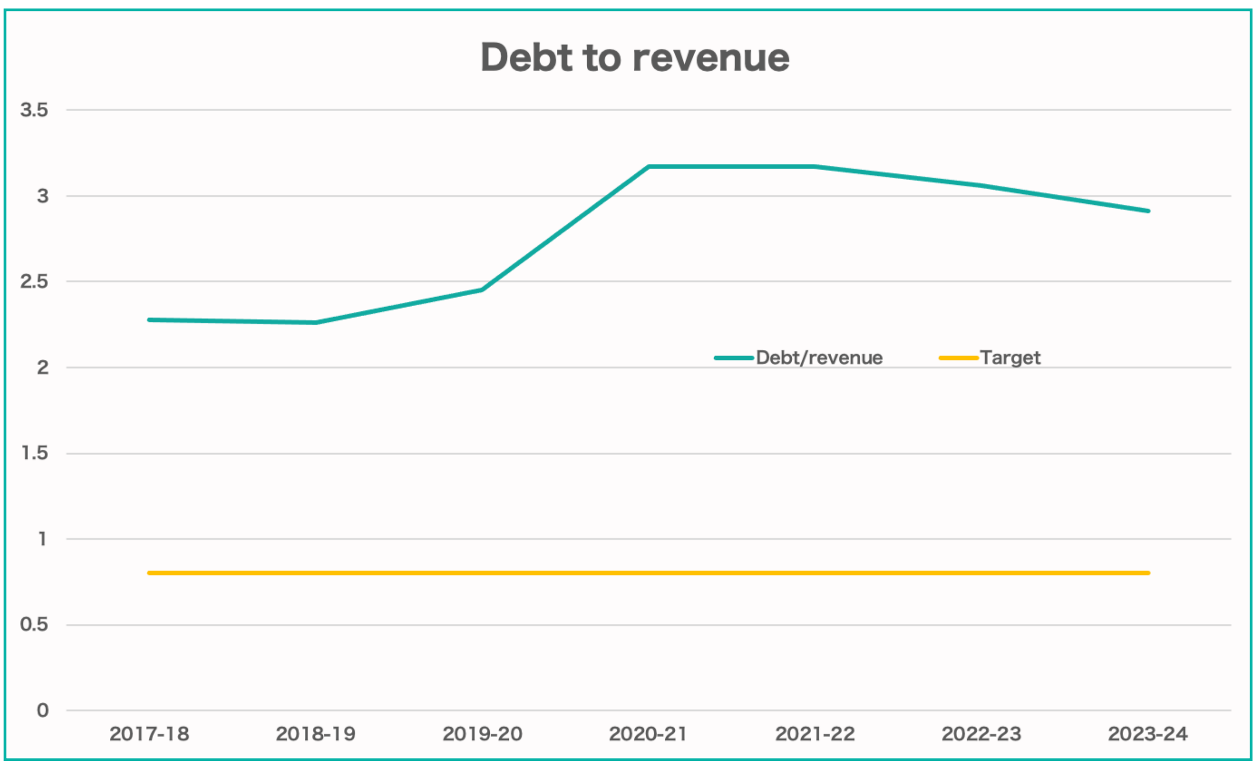
56. On the revenue side, the Budget appears to be based on a scenario under which GDP returns to its 2019 level by the end of 2022 (a broadly similar speed of catch-up as the IMF projections for the world economy). The assumption appears to be that revenues will recover automatically as the economy recovers. Revenues are forecast to rise 4% this year, broadly in line with economic growth, to $998.9 million. Beyond that, the Budget assumes that revenues will grow by 5% per year, returning to approximately their pre-pandemic level by 2023–24. This revenue growth is premised on increasing the size of the economy only—not upon any plan to change tax rates or to add new taxes. The Government has in fact explicitly ruled out tax increases in the short-term, while the economy is still recovering from the pandemic, and has not as yet set out any substantive plans to boost revenues, either through increases to existing taxes or tax reforms. This year there were no new revenue generating measures other than an increase in company registration fees. Indeed, several tax reliefs and incentives have been extended. The 2015 land valuation list will now remain in force for a further 10 years, meaning that there will be no increases to land tax, and the bands will remain unchanged over that time. However, in line with our recommendation, the Minister of Finance plans to renew and broaden the remit of the Tax Reform Commission; while it is expected to have an initial focus on global plans for international corporate taxation changes, given the time sensitive nature of this matter, the full taxation landscape to be examined by the TRC will not be limited to this issue.

57. These projections imply that net debt would peak in cash terms at just over $3.2 billion in 2022–23 as the Sinking Fund is run down (gross debt would remain at $3.35 billion unless the Government chose to replenish the Sinking Fund through a further refinancing exercise). While, as shown in the Box below, the Government's plans are consistent with its new fiscal guardrails, there is limited room for further slippage. The debt to revenue ratio would remain close to 300%, in sharp contrast to the government's long-term objective of 80%, while the debt service to revenue ratio would be about 12%, in excess of the target of 10%.

58. In addition, there are, as of March 31, 2020, outstanding financial guarantees totalling $952 million, most of which relate to the Acute Care Wing of the hospital. Most recently, an additional commitment to guarantee $10 million of funding of a new hotel project on the site of the former Grand Atlantic on Bermuda's southern shore was made in the budget. As discussed in more detail below, there are significant actuarial funding gaps in the Public Sector Superannuation Fund (PSSF), the Government Employees Health Insurance Fund (GEHI) and Bermuda's Contributory Pension Fund (CPF). In other words, in assessing Bermuda's fiscal sustainability over the long-term, simply looking at on-budget revenues and expenditures gives a partial and, in some respects, over-optimistic picture.



Performance against debt/GDP limits
60.00%
50.00%
40.00%
30.00%
20.00%
10.00%
0.00%
2017-18
2018-19
2019-20
2020-21
2021-22
2022-23
2023-24
Gross debt/GDP
Net debt/GDP
Gross debt limit
Net debt limit



Debt to revenue
3.5
3
2.5
2
1.5
1
0.5
0
Debt/revenue
Target
2017-18
2018-19
2019-20
2020-21
2021-22
2022-23
2023-24

59. From our perspective, charged as we are with assessing both the Government's compliance with its fiscal rules over the short and long term, and its wider fiscal and macroeconomic strategy, this gives rise to two sets of concerns:

1) In the short term (that is, until 2023–24), although the fiscal trajectory set out by the Government is both broadly sensible (albeit we had recommended a somewhat more aggressive approach) and consistent with the rules, it leaves the Government exposed to significant risks – that this very prolonged period of spending restraint is not sustainable, either politically or economically, or that revenues fail to recover as quickly as projected, either because of economic weakness or because the extent of structural damage from the pandemic is greater than expected.

2) Over the medium to long term, the Government has no strategy to boost revenues or to reduce debt from its very elevated post-pandemic levels. The pandemic will have increased Bermuda's net debt by more than $400 million, the debt to GDP ratio by more than 5 percentage points, and the already too high debt to revenue ratio by about 40 percentage points. While the current fiscal path will keep debt within the "guard rails", there is relatively little room for manoeuvre. And the prospect of meeting the debt to revenue target, or even making substantial progress towards it, remains far removed. Since, in our view, this target is the most important to long-term fiscal sustainability – and therefore to Bermuda's credibility with international financial markets – this remains a very serious concern.

Box 4: Compliance with the Government's fiscal rules: The Panel's Assessment

1) Progress towards the Bermuda Government achieving a balanced budget by fiscal year 2023/24.

The Budget sets out a path towards achieving a balanced budget by fiscal year 2023–24, relying on tight controls on spending and a robust recovery in revenues. We commend progress on this front, although we note that significant risks remain.

2) Compliance with the fiscal guardrails that Government has established — ratio of gross debt to GDP not to exceed 55%; ratio of net debt to GDP not to exceed 50%; and debt service to GDP not to exceed 3%.

Bermuda's current level of GDP (in 2020) is $6.85 billion, implying limits of approximately $3.8 billion, $3.4 billion, and $200 million, for gross debt, net debt and debt service respectively, in the current year.

With net debt peaking at $3.2 billion, while gross debt remains at $3.35 billion, and debt service costs of approximately $128 million, while GDP should recover in 2021 and beyond, we expect all the guardrails to be observed throughout the forecast period.

3) Prospects for further progress towards meeting the longer-term 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.

Net debt is currently more than 3 times revenues, and this ratio will only fall slowly over the forecast period. The lack of a strategy to boost the revenue/GDP ratio, currently about 14%, remains our most serious concern.

G. The Way Forward

Fiscal strategy

60. The Government's commitment to budget balance by fiscal year 2023–24, and its presentation of a 2021 Budget consistent with that goal, is welcome. However, we are not persuaded that it will be feasible in practice to finance the Government's ambitious commitments to economic and social development, as set out in the ERP and elsewhere, which will take some time to make a positive contribution to the fiscal position, without a significant modernisation and broadening of the tax base; nor that the current structure of the tax system is consistent with long-term fiscal sustainability.

61. We remain of the view that current plans expose Bermuda to an unacceptable level of risk, resulting from either a rise in US and global interest rates, or from market sentiment towards Bermuda specifically. We are also concerned that while the current fiscal targets and guardrails set a clear short-term objective (balance by 2023–24) they do not in practice provide a means of delivery nor any clear guide to policy thereafter, since on the one hand no further progress would be required to meet the debt/GDP guardrails, while the debt/revenue target will remain far out of reach for the foreseeable future.

62. We therefore recommend that at the next Budget the Government commits to a further set of specific time-bound objectives for revenue and budget balance after 2023–24. Consistent with our previous reports, the Government should target a budget surplus of $50 million per annum, to be achieved by fiscal year 2026–27, and continued thereafter to pay down the debt and to demonstrate real progress towards the debt-revenue target.

Tax Policy

63. In the short term, the immediate challenge facing the Government is how to respond to international plans for a minimum effective rate of corporate income tax on the income of the largest global multinational enterprises. The advent of the global minimum tax could prove an opportunity for Bermuda. The government's objective in this regard has been stated as seeking a "win-win" solution working in conjunction with the Bermuda international business sector. Ideally, where various Bermuda headquartered MNEs, and Bermuda based subsidiaries of other affected MNE groups, will need to pay increased corporate income taxes in some country, or set of countries, to reach the effective minimum rate, the Government should aim to see that a significant share of the increased total taxes that will fall on its international financial business sector accrue to Bermuda rather than elsewhere–while still preserving the attractiveness of the island as a location for international business.

64. We agree that the remit of the TRC should not be confined simply to international issues. We remain of the view that Bermuda's tax system requires fundamental restructuring. The Government is constrained in the short term by its understandable commitments not to raise taxes during the recovery. Nevertheless, that does not preclude the development of a medium term tax strategy based around the following principles, all of which are consistent with the Government's long-standing objectives, as well as with our medium term fiscal objectives proposed above:

- raising Bermuda's tax ratio to a level commensurate with comparator countries

- moving toward a more progressive tax structure that taxes earnings from capital (that is, interest on investment, dividends and rental income) as well as labour.
- Broadening the tax base while disincentivising behaviour that is damaging to health or the environment, for example by introducing a form of carbon or non-renewable energy tax, and exploring further reliance on "sin" taxes.

To the extent that developments on international corporate tax result in increased revenue, the Government should, rather than using such revenue simply to cut other taxes, see this as an opportunity both to reduce the debt and to reform and restructure the tax system along the lines above.

Expenditure Policy

65. In our last report, we argued that the Government would need to impose a tight budgetary regime in 2021–22 and an across the board cut in most major spending departments and agencies. Although crude, it was judged to be both justified and necessary. However, after cutting expenditure by 5.1% in the teeth of the pandemic in 2020–21, the 2021 budget increased current spending, excluding debt service and the now discontinued contributions to the Sinking Fund, by around 1% a year, barely enough to cover inflation, in each of the next three years to 2023–24. Such continued austerity may be challenging to achieve, particularly against the background of the ambitious policies set out in the Economic Recovery Plan, and the need to renew and modernise Bermuda's public infrastructure.

66. Over the medium term, more fundamental reforms are required. While there have been various previous government initiatives (the Sage Commission Report, the Efficiency Committee's agenda for action, and recent zero-based budgeting efforts), this has not yet translated into significant savings. Recently, the Government has sought to shift from a functional to a service-centric budget and the Government's election manifesto called for investments that can make the provision of public services more efficient. Current policies of attrition now need to be paired with a new Sage Commission, one that can propose ways to deliver public services within a tightened budget. This should include revisiting the role and cost of the many quangos in the public sector and, where appropriate, buyout packages for redundant public sector workers.

67. The Government also needs to exercise restraint in the provision of guarantees, and other policies that result in contingent liabilities for the Government. Recent experience shows that such liabilities, while initially appearing to be cost-free, can manifest themselves as a call on the budget resulting in large, unplanned increases in expenditure and hence debt; moreover, they undermine confidence in the Government's overall fiscal strategy. The Government should make clear that guarantees will not normally be issued to back commercial projects, and that any guarantees will require a very clear and persuasive business case to show they are both essential to the viability of specific projects and represent an acceptable balance of risk and reward to the taxpayer.

The Economic Recovery Plan

68. We welcome the Government's commitment to the ERP and advancing its seven themes of economic diversification, making financial markets work better for Bermudians, infrastructure, population, healthcare, labour market and social reform, and an enabling legislative and regulatory architecture. We are encouraged to note that significant progress has already been made with projects in several areas, particularly economic diversification, immigration, renewable energy and reducing medicine costs. But others remain in the planning stage. Implementing such a wide-ranging agenda is likely to be very challenging indeed. The Government has engaged KPMG to establish a Project Management Office within the Cabinet Office, reporting to the Cabinet Committee on Economic Development and the Premier. This will certainly improve focus at the centre of government and highlights the priority attached to the ERP. But delivery will require action across government in virtually every department, which may strain administrative capacity and resources, particularly after the pressures of the last two years.

69. While not all proposals within the ERP require increased public spending, some will. Given the Government's commitment to balance the budget, which in turn requires minimal spending increases in the next two years, this is likely to require substantial reprioritisation – bluntly, other non-priority expenditures will need to be reduced. Moreover, we would caution against the temptation to use off-budget expenditures and commitments – for example, the provision of government guarantees, or use of state pension funds as a source of finance – to advance the proposals under the ERP without increasing recorded public spending. This would increase contingent liabilities, which has proved very damaging to Bermuda's public finances in the past.

Improving Bermudians' Access to Finance and Banking.

70. For some years the Panel has been concerned about the underdeveloped nature of Bermuda's capital markets, Bermudians' access to bank and venture capital finance, and the level of mortgage rates, as well as a shortage of domestic investment opportunities for Bermudians. By harnessing new technology and streamlining processing to offer retail banking services more cheaply, and increase competition in the banking sector, the proposed Bermuda Digital Bank (BDB), offering predominantly online services to personal customers and small and medium sized businesses could potentially make an important contribution.

71. However, there are a number of potential risks. A new bank will need to be capitalised; if some or all of its capital were to come from government directly, from government funds including pension funds, or be guaranteed by government, this would represent another source of potentially substantial risk to government's long term financial position. Any initial government start-up capital should be strictly limited, and there should be clear legislative and/or contractual provisions making clear that there is no scope for additional government finance provided directly or indirectly, and that the BDB does not benefit from any Government guarantee, direct or implicit. Any share offering to Bermuda's citizens should also be carefully regulated to protect the public from undue risk.

72. It is vital to the health of the Bermuda economy and its public finances that nothing should be allowed to jeopardise Bermuda's hard-won reputation as a well-regulated global financial centre, fully compliant with all international standards and regulations. The BDB must be fully independent of government, commercially viable on a stand-alone basis, and subject to all the normal regulatory and supervisory requirements and procedures of the BMA.

73. A new digital bank will not address all of the factors responsible for the lack of access to quality banking services experienced by many Bermudians. Other potential issues include a lack of competition between banks and barriers to entry in the retail banking market; banks' access to retail customer credit scoring and other data, and other barriers to writing new business; strengthening consumer protection in financial services; payment systems; and the lack of liquidity in Bermudian residential real estate or a secondary mortgage backed securities market. Also inhibiting access to finance is the absence of any requirement that businesses provide routine financial statements or accounts, and absence of clear legal procedures for handling company failures in the non-financial sector. Especially for small businesses, this may hinder their access to capital.

74. The ERP also provides for the introduction of a Bermuda base interest rate. While increased transparency in interest rate setting is a laudable aim, it should be noted that, with the Bermuda dollar pegged to the US dollar, Bermuda cannot independently set a base rate.

Immigration

75. The ERP commitment to expand the resident population and to modernise immigration policy and administration is in line with our long-standing recommendations on this topic. The Government has taken important and welcome steps in this regard. From January 2022 any person who has been ordinarily resident in Bermuda for 20 years or more, non-Bermudian parents of a child with Bermudian Status ordinarily resident in Bermuda for 15 years or more, and children born to 2nd Generation Permanent Resident's Certificate (PRC) holders and who have been ordinarily resident in Bermuda can apply for a PRC. This improves upon the 2020 Repatriation and Mixed Status Families legislative amendments enabling families to remain together, which allowed for persons born overseas to Bermudian parents to be Bermudian from birth.

76. But more needs to be done. Immigration offers an important counterweight to the negative impact of Bermuda's adverse demographics on its potential growth and wellbeing, and the long-run sustainability of the pension and health systems. Bermuda's system is highly restrictive: most advanced economies allow long-term residents to apply for permanent residency – and often citizenship – after 5–10 years; moreover, children of long-term residents are generally eligible for citizenship either at birth or when they become adults. Bermuda needs to make it easier, not just for people to come to work, but to stay, contribute and invest in the Island on an ongoing basis, and, eventually, to settle permanently, with appropriate rights, responsibilities, and security for their families and children. Similarly, obstacles facing Bermudians currently resident abroad who wish to return, with family members, should be removed.

77. The "Work from Bermuda" scheme is a welcome and, so far, broadly successful innovation, which should be broadened, perhaps by giving much longer residency permits rather than requiring annual renewal. In addition, much more could be done to streamline and modernise the work permit system perhaps by adopting a risk-based approach (that is, a quicker procedure for trusted employers). The current moratorium on work permits for a number of sectors and occupations appears to be having unintended consequences, slowing recovery from the pandemic and – paradoxically – inhibiting employment growth for Bermudians in jobs related to that of the prospective work permit holder. It should be lifted or at least scaled back substantially.

78. Meanwhile, we welcome the Government's commitment to improve the speed and efficiency of processing through the introduction of automated systems. But to deliver dividends this will require political, institutional and financial commitments across a number of dimensions: investment in the necessary IT and systems; speedy and efficient procurement processes; and perhaps most of all streamlining of the underlying processes. A fast, flexible and efficient immigration system is essential to Bermuda's economic success; this should be a key priority in the implementation of the ERP.

Health

79. Bermuda's health care costs are among the highest in the world and its ageing population has a high incidence of chronic illness. The introduction of the Bermuda Health Plan (BHP) is planned to provide, affordable, universal, health coverage (UHC), covering a wider range of services than the Standard Health Plan it replaces. It is to be provided by a unified or single insurer, allowing for supplemental private insurance coverage.

80. Our 2019 report examined the principles of the proposals and broadly endorsed them. They build on international experience gained among the more successful advanced and emerging market countries in providing cost-effective health care in the context of an ageing population. It is encouraging to note that the BHP has been included in the Economic Recovery Plan and should therefore benefit from the PMO, working with the UHC Steering Committee headed by the Minister of Health, to ensure timely delivery. Reforms will be necessary to shore-up the financing of the system and these will most likely require greater progressivity in burden sharing, both among taxpayers and the elderly. Risks, both financial and related to the implementation of the reforms, are being mitigated by an incremental approach to implementation, starting with the public sector schemes.

Pensions

81. The foundations of Bermuda's social insurance system have been undermined by long-standing demographic developments and lack of policy resolve. There are significant actuarial funding gaps in the Public Sector Superannuation Fund, the Government Employees Health Insurance Fund and the Contributory Pension Fund. As of March 2020, the PSSF had assets of about $610 million, accrued liabilities of $1.635 billion, and hence an actuarial deficit of more than $1 billion. Meanwhile, the GEHI, which is not funded, has accrued future obligations of an estimated $780 million. The position of the CPF is unclear, since it has not published full accounts since 2012, a situation rightly described by the Auditor General as unacceptable and inexcusable. Although CPF benefits are not technically an obligation of Government, in practice it would be difficult or impossible for the Government not to make good any shortfall.

82. Taken together, the position is clearly unsustainable; pension obligations constitute significant potential future contingent liabilities which could add to the burden of the Government's mounting debt, while it would be politically, morally and economically disastrous for the Government to renege on these obligations. Moreover, the COVID–19 suspension of Government employee and employer contributions for pensions and social insurance for a year, and the decision to allow private sector employees to withdraw some of their pension savings, will have widened these gaps.

83. Pension reform in Bermuda will, as elsewhere, require a combination of measures, including increased contributions (whether through raising contribution rates, the number of contributors, or some combination of the two), adjusted benefits, and higher retirement ages, reflecting increased longevity and working lives; all this is simply arithmetic. The alternative is that the funds will simply run out of money to pay future pensions.

84. In particular, we believe that the Government should, after due consultation with stakeholders, (i) substantially increase, in a phased manner, the retirement and pensionable age of most public service workers enrolled in the PSSF and CPF; (ii) increase the reference wage period to reflect a longer period before retirement; and (iii) increase contributions in an equitable manner. A package of measures along these lines would bring Bermuda more in line with comparator countries and would go a long way towards making the Bermudian pension structure more sustainable in the face of very severe financial and demographic challenges. Further delay will simply make the problem worse, and we urge the Government to act speedily. We also note that a significant and sustained increase in net migration of economically active working-age people to Bermuda would raise the number of contributors to the CPF and help improve pension fund finances, and this should form part of the Government's broader strategy.

85. Finally, the Government should not in future have recourse to temporary suspensions of pension contributions designed solely to reduce deficits from an accounting perspective, while worsening the long-term sustainability of government-backed pension schemes. We welcome the Government's assurances that these measures were purely temporary and exceptional, and will not be repeated.

Climate Change

86. In recent reports the Panel has called for a designated government department to coordinate the island's response to climate change, ensuring that the response to the considerable risks posed to the island is embedded in all decision making. We are heartened that the Ministry of Home Affairs, under the leadership of the Deputy Premier, has established a Climate Task Force working across government It will be crucial to ensure that this function is adequately resourced going forward. The UK Overseas Territories Marine Climate Change Impacts Partnership welcomes that "the importance of mainstreaming climate change into all government strategies, spending and investment decisions" is highlighted by the region's developing climate change policies.

87. In the light of the financial constraints facing Bermuda, the focus should be on resilience to climate change in terms of reducing Bermuda's vulnerability to extreme weather events, sustainable development, improving coastal and ocean management and leveraging the opportunities offered by Bermuda's natural mangrove and sea grass carbon sinks. Bermuda's contribution to global emissions is minuscule and significant expenditure on reducing it further should not of itself be a priority; only where investment in is in any case taking place, or has other significant benefits, should steps be adopted to reduce the country's carbon footprint. One area of importance in this regard is developing sources of renewable energy in line with the proposals in the ERP. By replacing expensive imported fossil fuels, this offers considerable potential economic benefits to the island and should be pursued.

88. Many small states in the Caribbean have revisited their public investment appraisal processes to ensure an adequate rate of return on capital expenditure. This is advisable and should include assessment of whether existing and proposed capital infrastructure is resilient to the potential impact of climate change, a rising sea level, and natural disaster shocks. These additional hurdles should be incorporated in assessing and implementing projects under the Economic Recovery Plan, and the planning system should be used to ensure that new private sector capital expenditure is also climate resilient.

H. Conclusions and Recommendations

89. On present plans, the Government will remain within its new fiscal guardrails, for the ratios of gross and net debt to GDP, for the forecast period. We strongly endorse the Minister of Finance's clear commitment to remaining within the spending allocations for this year set out in the 2021 Budget. However, the debt to revenue ratio, at over 300%, remains far above the target of 80%, and in addition there are significant contingent liabilities. Since, in our view, the debt to revenue target is the most important to long-term fiscal sustainability – and therefore to Bermuda's credibility with international financial markets – this remains a very serious concern.

90. Moreover, significant risks remain; in particular, that this very prolonged period of spending restraint is not sustainable, either politically or economically, or that revenues fail to recover as quickly as projected. We are not persuaded that it will be feasible in practice to finance the Government's ambitious commitments to economic and social development, as set out in the ERP and elsewhere, which will take some time to make a positive contribution to the fiscal position, without a significant modernisation and broadening of the tax base; nor that the current structure of the tax system is consistent with long-term fiscal sustainability. Over the medium term, the Government needs to boost revenues to reduce debt from its very elevated post-pandemic levels and to manage the considerable contingent liabilities.

91. Bermuda's most fundamental challenge is demographic; a shrinking workforce and an ageing population inevitably undermines the sustainability of the pension and health systems. Both systems require reform, but a growing working population would make a major contribution.

92. Pressing challenges include: the need to restart economic growth, in the traditional economic sector of tourism and related services and more broadly through further diversification; the need to modernise the tax system in the context of global discussions on minimum corporate tax rates; and of course climate change.

93. Our key recommendations cover both fiscal issues and broader structural reforms needed to put the public finances on a more sustainable long term path:

- **Fiscal strategy:** The Government's commitment to budget balance by fiscal year 2023–24, and the Minister's commitment to sticking to the 2021–22 spending allocations, are very welcome. However, we are concerned that there is no clear guide to policy thereafter. We therefore recommend that at the next Budget the Government commits to a further set of specific time-bound objectives for revenue and budget balance after 2023–24. Consistent with our previous reports, we recommend the Government target a budget surplus of $50 million per annum, to be achieved by fiscal year 2026–27, and continued thereafter, to pay down the debt and to demonstrate real progress towards meeting the debt-revenue target.

- **Tax strategy:** The immediate challenge facing the Government is how to respond to international plans for a minimum effective rate of corporate income tax on the income of the largest global multinational enterprises. However, this could be an opportunity. The Government should aim to ensure that a significant share of the increased total taxes that will in any event fall on its international financial business sector accrues to Bermuda rather than elsewhere – while still preserving the attractiveness of the island as a location for international business. We remain of the view that Bermuda's tax system requires fundamental restructuring, and the

Tax Reform Commission should be charged with developing a medium term tax strategy to increase tax revenues by moving toward a more progressive tax structure that taxes earnings from capital, including interest, dividend and rental income, as well as labour, and broadens the tax base while disincentivising behaviour that is damaging to health or the environment.

- **Expenditure Policy:** Continued austerity may be challenging to achieve, particularly against the background of the ambitious policies set out in the Economic Recovery Plan (ERP), and the need to renew and modernise Bermuda's public infrastructure. Over the medium term, more fundamental reforms are required. The Government also needs to exercise restraint in the provision of guarantees. The Government should make clear that guarantees will not normally be issued to back commercial projects, and that any guarantees will require a very clear and persuasive business case to show they are both essential to the viability of specific projects and represent an acceptable balance of risk and reward to the taxpayer.

- **The Economic Recovery Plan:** We welcome the Government's commitment to the ERP. We are encouraged to note that significant progress has already been made with projects in several areas, particularly economic diversification, immigration, renewable energy and reducing medicine costs. However, implementing such a wide-ranging agenda is likely to be very challenging indeed. Delivery will require action across government in virtually every department, which may strain administrative capacity and resources.

- **Bermudians' Access to Finance:** The Bermuda Digital Bank could potentially make a major contribution to improving Bermudians' access to finance. However, if some or all of its capital were to come from government directly or indirectly, this would represent another risk to the long-term fiscal position. Any initial government start-up capital should be strictly limited, and there should be clear legislative and/or contractual provisions making clear that there is no scope for additional government finance provided directly or indirectly, and that the BDB does not benefit from any government guarantee, direct or implicit. Moreover, nothing should be allowed to jeopardise Bermuda's hard-won reputation as a well-regulated global financial centre. The BDB must be fully independent of government and subject to all the normal regulatory and supervisory requirements and procedures of the Bermuda Monetary Authority.

- **Immigration:** We welcome the commitment to expand the resident population and to modernise immigration policy and administration, and significant progress has been made; but more needs to be done. Immigration offers an important counterweight to the negative impact of Bermuda's adverse demographics on its potential growth and wellbeing, and the long-run sustainability of the pension and health systems. The "Work from Bermuda" scheme is a welcome innovation, and could be broadened. In addition, much more could be done to streamline and modernise the work permit system, which would improve the business ecosystem. We also welcome the Government's commitment to improve the speed and efficiency of processing; this will require political, institutional and financial commitments across a number of dimensions: investment, speedy and efficient procurement processes; and perhaps most of all streamlining of the underlying processes.

- **Health:** We broadly endorse the Government's reform proposals, especially the introduction of the Bermuda Health Plan (BHP), which is planned to provide affordable, universal, health coverage. The incremental approach to implementation, starting with the public sector schemes, appears sensible and should help mitigate risks.

- **Pensions:** Pension reform in Bermuda will, as elsewhere, require a combination of measures, including increased contributions (whether through raising contribution rates, the number of contributors, or some combination of the two), adjusted benefits, and higher retirement ages, reflecting increased longevity and working lives; all this is simply arithmetic. The alternative is that the funds will simply run out of money to pay pensions. We believe that the Government should, after due consultation with stakeholders, (i) substantially increase, in a phased manner, the retirement and pensionable age of most public service workers enrolled in the PSSF and CPF; (ii) increase the reference wage period to reflect a longer period before retirement; and (iii) increase contributions in an equitable manner. A package of measures along these lines would bring Bermuda more in line with comparator countries and would go a long way towards making the Bermudian pension structure more sustainable in the face of very severe financial and demographic challenges.

- **Climate Change:** We welcome the establishment of the Climate Task Force working across government; it will be crucial to ensure that this function is adequately resourced going forward. In the light of the financial constraints facing Bermuda, the focus should be on resilience to climate change in terms of reducing Bermuda's vulnerability to extreme weather events, sustainable development, improving coastal and ocean management and leveraging the opportunities offered by Bermuda's natural mangrove and sea grass carbon sinks. We would encourage the Government to carry out an assessment of the physical, economic and fiscal risks that climate change might pose to the Island, and where necessary invest further in measures to improve its resilience. Bermuda's contribution to global emissions is minuscule and significant expenditure on reducing it further should not be a priority; only where investment is in any case taking place, or offers other significant benefits to Bermuda, should focus be on reducing the country's carbon footprint. Developing sources of renewable energy to replace imported fossil fuel, in line with the proposals in the ERP, does offer considerable economic benefits to the Island and should be pursued.

94. Bermuda has now largely emerged from the worst of the pandemic; in our view, with the right policies, the prospects of the Island are bright. The potential of the Island and its people should not be in doubt. While many long-standing challenges remain, policies to address them are being developed, and we were impressed by the sense of urgency on the part of the Government and the shared commitment of other stakeholders.

Annex A: List of Meetings Held by the Panel

(November 18–29, 2021)

The Honourable David Burt MP, Premier

The Hon. Walter Roban, JP, MP, Deputy Premier and Minister of Home Affairs

The Honourable Curtis Dickinson MP, Minister of Finance

The Honourable Wayne Furbert MP, Minister for the Cabinet Office

The Hon. Jason Hayward, JP, MP, Minister of Labour

The Hon. Kim Wilson, JP, MP, Minister of Health

Officials from the above-mentioned Departments

The Honourable Cole Simons M.P, Leader of the Opposition, and other representatives of the Opposition

Mrs. Cherilyn Whitter, The Deputy Head of Public Service

Mr Barclay Simmons, Chairman of the Pension Funds Investment Committee

Association of Bermuda Insurers and Reinsurers

Bermuda Bankers Association

Bermuda Monetary Authority

Bermuda Tourism Authority

Bermuda Trade Union Congress

Bermuda Chamber of Commerce

Dr. Mark Guishard, Bermuda Weather Service

Nathan Kowalski