Fiscal Responsibility Panel

2016

Annual Assessment

Bermuda

David Peretz (Chair)
Peter S. Heller
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December 2016

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Cover photo: Team BDA, Bermuda's entry into the Red Bull Youth America's Cup
Photo: Peter Backeberg/Team BDA

List of Acronyms

AML: Anti Money Laundering

BELCO: Bermuda Electric Company

BHB: Bermuda Hospitals Board

BMA: Bermuda Monetary Authority

BTA: Bermuda Tourism Authority

CARTAC: Caribbean Technical Assistance Center

CFATF: Caribbean Financial Action Task Force

COLA: Cost of Living Adjustment

CPF: Contributory Pension Fund

CPI: Consumer Price Index

CTF: Counter-terrorism Financing

DRG: Diagnostic Related Group

G20: Group of 20 Major Economic Powers

GEHI: Government Employees Health Insurance Fund

GDP: Gross Domestic Product

GST: General Services Tax

HIP: Health Insurance Plan

IMF: International Monetary Fund

MMLPF: Ministers and Members of the Legislature Pension Fund

MRF: Mutual Reinsurance Fund

MS: Morneau-Shepell, a private actuarial consulting firm

NPS: National Pension Scheme

MTEF: Medium-Term Economic Framework

OECD: Organization for Economic Cooperation and Development

PSSF: Public Service Superannuation Fund

PBWG: Pension and Benefits Working Group

SAGE: Spending and Government Efficiency Commission

SHB: Standard Health Benefit

VAT: Value Added Tax

Executive Summary

As we set out in our 2015 report, Bermuda's economy faces a number of risks and uncertainties in both the short and longer term. Our judgement is that with Brexit, the US elections, and the impending evaluation of the island's anti-money laundering/counter-terrorism financing regime, these risks have increased. The current level of government debt – combined with very large potential liabilities from government guarantees and underfunded public pension and health insurance schemes – means that any negative shock resulting from these or other factors, internal or external, could have very serious economic consequences. Reducing government debt and debt service costs mitigates these risks and will make the island's economy more resilient to any such shock; it must therefore remain an overriding priority. In 2015-16 there was a current primary surplus and in the current year the debt to revenue ratio is expected to fall slightly. These are important milestones on the road to fiscal sustainability, but there is much more to be done.

In our report last year we:

- Endorsed the Government's aims of achieving a balanced budget in 2018/19; and over the longer term of meeting the targets set for the ratios of debt and debt service to revenue.
- Suggested that economic circumstances provided a window of opportunity for making rapid progress; and suggested setting a target for meeting the debt and debt service ratios 5 years after achieving budget balance in 2018/19.
- Proposed measures to tighten fiscal policy by the equivalent of 2 1/2 % of GDP, on top of the already planned expenditure reductions of 2% of GDP. To allow for slippages we suggested raising revenues by the equivalent of 3% of GDP.
- We noted that to deliver the expenditure reductions built in to the Government's plans would require structural reforms in the way that services are delivered, and we made some suggestions about the ways to go about prioritizing budget allocations.
- And we made a number of suggestions both for tax measures that could be implemented quickly and for possible longer-term reforms in the tax structure.

We also noted that Bermuda faces a serious demographic challenge which contributes to the underfunding of pension schemes and will increase health care outlays. Early steps to adjust some of the terms and features of government pension schemes and address the way in which health policy objectives are achieved are needed to reduce projected deficits. This would include encouraging increases in the length of working lives. We also suggested that policy should be designed to meet an objective that net immigration of those of working age should be positive, significant and sustained by the end of the decade, and linked to the fostering of growth.

All these recommendations remain relevant. In its 2016 Budget the Government announced actions that, if implemented, will meet many of our most important recommendations for the short term. In particular we welcome the scale of the proposed increase in revenues, which is in line with what we suggested would be needed to meet the Government's debt objectives. We note that several of the detailed tax proposals including the reform of payroll tax, the introduction of a general services tax (GST) and the phasing out of some special tax concessions are in line with our suggestions. We also agree with the statement in the Budget that meeting the Government's objectives for reducing expenditure will require a more radical and structural approach than that taken up to now. And we welcome some initial steps taken to address underfunding of public pension schemes and to control health care costs.

While these announcements are welcome, however, implementation is presenting a challenge. As yet there have been few actions of the kind that will be needed to improve efficiency and to deliver significant further expenditure reductions over the years ahead. While there have been a number of departmental efficiency studies the main measures adopted so far - a continuing across-the-board hiring freeze combined with continued encouragement for early retirement of public servants – are reaching the limits of their effectiveness. And while progress on payroll tax reform is welcome, there are clearly limits to how much additional revenue can be raised from this source without doing damage to Bermuda's businesses and employment. The delay in developing proposals for the new GST is also disappointing. Determined action is needed if a shortfall in revenue is to be avoided in 2018/19 and possibly in 2017/18 as well.

Action is therefore needed on both revenues and spending if the deficit targets for the next two years are to be met. On expenditure we repeat the recommendation we made last year: structural changes are required in the way services are delivered. Such measures may take time to implement, but given the likely scale of longer-term pressures a start needs to be made now. On revenue, there is much to be done to ensure successful implementation of payroll tax reform, and even more to be done to design and implement a new services tax. Extra resources are urgently needed at the Ministry of Finance and the Office of the Tax Commissioner if these two reforms are to be implemented on schedule. We also recommend taking steps to develop contingency plans to fill any shortfall in revenues over the next two years from delays or shortfalls from payroll tax reform and GST introduction. We suggest a number of other ways the Government could raise additional revenue to make good any shortfall.

Turning to longer term issues, while the Budget forecast of a small financial surplus in 2018/19 is encouraging, we continue to recommend setting a timescale for meeting the debt objectives. The unfunded liabilities of government pension and health insurance schemes will need to be addressed by a combination of increases in contributions and changes in terms. Even then there will be rising pressures on the budget over time from the social and health care needs of an increasingly aged population. This constitutes an additional reason for tackling the debt overhang quickly, to open up fiscal space needed in the future.

Alongside these fiscal measures it will be important to take steps to adjust to the expected decline in the working age population and rise in the numbers of elderly; under present policies, the island simply will not be able to finance the required levels of social provision from a shrinking economic base. This requires early decisions on the policy measures needed to encourage longer working lives, including phased, pre-announced increases in the retirement age. A constructive social dialogue will be needed to address how to respond to the challenges arising from the poor health of many of Bermuda's elderly. And finally, it also requires a broader, more strategic approach to immigration policy, aimed at positive net immigration of people of working age, especially those that bring the skills needed for the new businesses the economy needs. We hope that after a period of public discussion and debate there will come to be wider acceptance of the importance of an appropriate level of net immigration, including the return of some of the Bermudians who have left in recent years, both for the health of the island's economy and for the continued viability of public pensions and health insurance schemes.

As we said in our report last year, we hope that this balanced set of measures to address Bermuda's fiscal, debt and longer-term demographic issues could over time gain a measure of broad support from all those who live on the island. We look forward to making a further assessment in a year's time.

I. Introduction

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

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

3. The rest of this report is structured as follows. Section II reviews the analysis and findings in our 2015 report and summarises and updates its recommendations. In Section III we comment on relevant Government actions taken and proposals made over the past year and assess progress in implementation of reforms. Section IV assesses the near-term fiscal prospects. Section V reviews economic prospects for Bermuda in the light of prospects for the global economy. Section VI reassesses prospects for meeting the Government's budget balance and longer-term debt targets. Section VII comments on progress on tax reform and the need to improve expenditure efficiency. Section VIII and Annex B look at the longer-term challenges of an ageing population and the viability of public pensions and health insurance schemes. And Section IX summarises our main findings, conclusions and recommendations. We look forward to reviewing progress and making a further assessment in a year's time.

II. Review of the analysis and findings in our 2015 report

4. In our report last year we noted the high level of economic vulnerability and risk faced by Bermuda, in common with other small island economies. In particular the economy's reliance on only two major industries means that a downturn in either of them has a major economic impact. And with a highly open economy, a fixed exchange rate regime and high levels of government debt and other potential liabilities from guarantees and underfunded pension and healthcare schemes, changes in global financial market sentiment could also have a major impact.

5. We highlighted a number of specific risks, none of which have diminished over the past year and some we believe have increased. Today the main risks include the following:

- *Risks from global initiatives in financial regulation.* The upcoming Caribbean Financial Action Task Force (CFATF) assessment of Bermuda's Anti-Money Laundering (AML) and Counter-Terrorism Financing (CTF) measures is critically important: a less than positive report would have both direct consequences (as foreign banks would be considerably more reluctant to do business with Bermuda-based banks) and indirect ones (as it would damage Bermuda's global image, and provide a useful excuse for those who would like to see further international regulatory action to reduce the attractiveness of Bermuda's business model). There would be high risk of major damage to Bermuda's financial services businesses. Many might choose to leave. We were, however, reassured by the obvious priority being attached to this issue at all levels of government.

- *Brexit.* Even if, as expected, the prospect of Brexit does have a depressing effect on UK growth (and to a lesser extent growth elsewhere in the EU) the impact on Bermuda will be small. However, the implications for Bermuda's financial sector over the medium to long term are far less clear. It may bring some new business opportunities to Bermuda. But while Bermuda does engage directly and regularly with officials in the European Commission in Brussels (and at the OECD), it also benefits considerably from the UK's voice and backing. Already the UK Commissioner is no longer responsible for financial services. And once Brexit is complete the UK will no longer be there to restrain those in the EU who object to Bermuda's zero rate of corporation tax, and who wish to include Bermuda on any blacklist of "non-cooperative" jurisdictions. The UK government has established a Ministerial-level committee to discuss the implications of Brexit for UK dependencies, and it will be important for Bermuda's government to engage fully. Less immediately, it will also be important to maintain Solvency II equivalence for insurance regulation; the European Commission will be reviewing Solvency II requirements at the end of 2018.

- *US tax reform.* President-elect Trump has promised a major reform of US corporate taxation, involving both the lowering of the US tax rate and greater incentives to repatriate profits. It is impossible as yet to predict how this might affect Bermuda, but there are some proposals in the Republican Party agenda for corporate tax reform that could have a major impact on Bermuda's insurance and reinsurance industry and there is no reason to believe that Bermuda's interests will be a high priority in Washington. On the other hand, it is also possible that US regulatory changes (in particular a greater role for state-level insurance regulation) may be positive for Bermuda.

- *The general rise in populism and economic nationalism, and retreat from globalisation, liberalisation and open markets* that is increasingly visible in political developments throughout advanced economies. Both Brexit and the election of Donald Trump are visible manifestations of this: but aside from the specific risks identified above, Bermuda has a lot to lose from any general move towards protectionism and economic nationalism, particularly if it affects international capital flows and attitudes to low and zero-tax jurisdictions. Moreover, Bermuda itself is not immune from such sentiments, as some of the tone of the debate on the

"Pathways to Status" proposals shows (see paragraph 16 below).

- *Uncertainties in the financial service and insurance industries.* Insurance, particularly the captive insurance and re-insurance business, and the wider financial sector including a small number of global banks, have constituted Bermuda's dominant and most successful industries in recent years. And achieving Solvency II equivalence arguably gives Bermuda a further competitive advantage in some respects. However, these financial service businesses are now seeing growing pressure on profit margins, partly as a result of technological developments, which seem likely to persist (and perhaps even accelerate) for the foreseeable future. Moreover, such pressures may in turn lead to structural change, in particular consolidation and disintermediation in the insurance industry, which could have significant direct impacts on Bermuda's economy. So far the Bermudian insurance and reinsurance business has done well in keeping pace – and even leading the way – in such innovations (for example the growth in insurance-linked securities (ILS)). This reflects the strong reservoir of intellectual capital in this sector resident in Bermuda; maintaining this competitive advantage requires continued supportive policy (in particular with respect to regulation and immigration).

- *Uncertainties in the tourism industry.* Even before the 2008 downturn, Bermuda's market share in tourism was in long-term decline. But in the last year there has been an encouraging turnaround with a significant increase in arrivals which looks set to continue with more, younger visitors coming to the island. The industry will get at least a temporary boost from the America's Cup in 2017. However, maintaining and improving Bermuda's attractiveness as a tourist destination is likely to remain a continuing challenge thereafter given shifting patterns and preferences in the tourist trade.

- *Events in global capital markets.* As we noted last year, with its high level of government debt, Bermuda is vulnerable to any rise in dollar interest rates. With debt interest already accounting for 12% of the annual budget revenues it is easy to see this could by itself lead to further downgrades by rating agencies. The recent successful bond issue shows that so far markets are keeping faith with Bermuda, and has removed the need for any further financing operation until 2019. Even so there is still a risk that some external event, such as problems in another similar island economy or the impact (perceived or real) of OECD tax initiatives or of the CFATF's AML/CTF assessment, could lead to further downgrades of Bermuda's credit rating. Such a downgrade would not only impact on the government's future borrowing costs. It would also have likely negative implications for financial businesses operating in the territory.

- *Impact of global warming and climate change.* Bermuda has always been vulnerable to weather events such as hurricanes that impact the whole territory. The island escaped with little damage from Hurricane Nicole, but may not be so fortunate in future. With global warming such extreme events are becoming more frequent. And in the longer term there will be the impact of rising sea levels to consider and adapt to.

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

- Bermuda's long history as a stable Parliamentary democracy broadly on the Westminster model is a significant economic asset. However, inevitably, there will be a period of uncertainty with respect to the direction of economic policy in the run-up to an election and its aftermath, as well as some risk that Ministers and senior officials will not be able to devote sufficient time and effort to the implementation of tax reforms currently in train.

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

6. Given these uncertainties and risks, which are if anything greater than they were a year ago, the build-up in public debt in recent years remains a serious concern. Charts 1a and 1b show just how rapidly debt and the key debt to revenue ratio have risen from historically much lower levels.

Chart 1a
Government net debt $000s

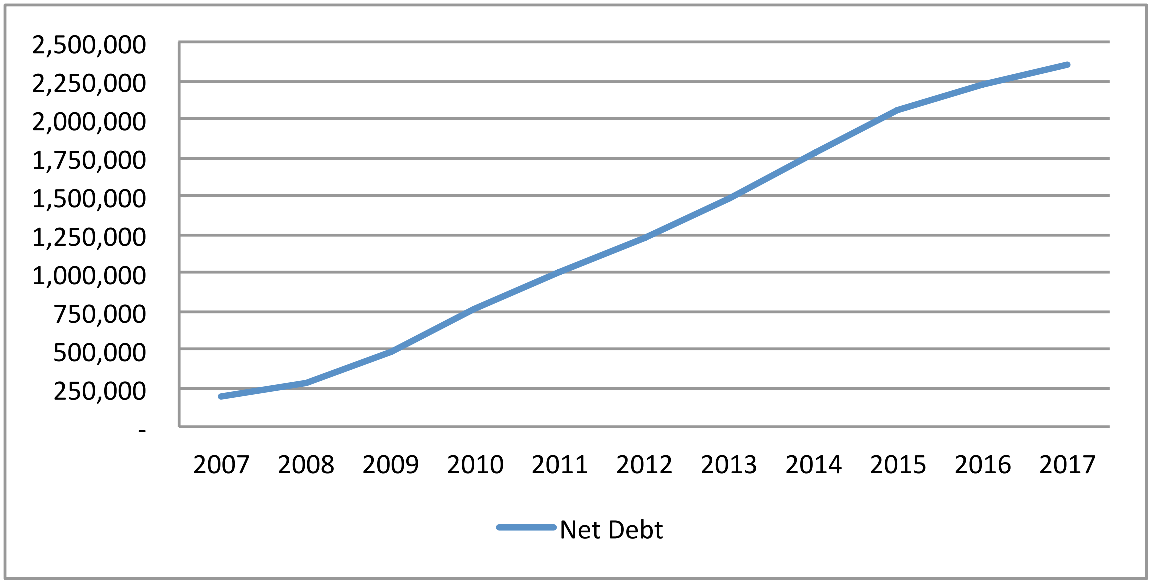
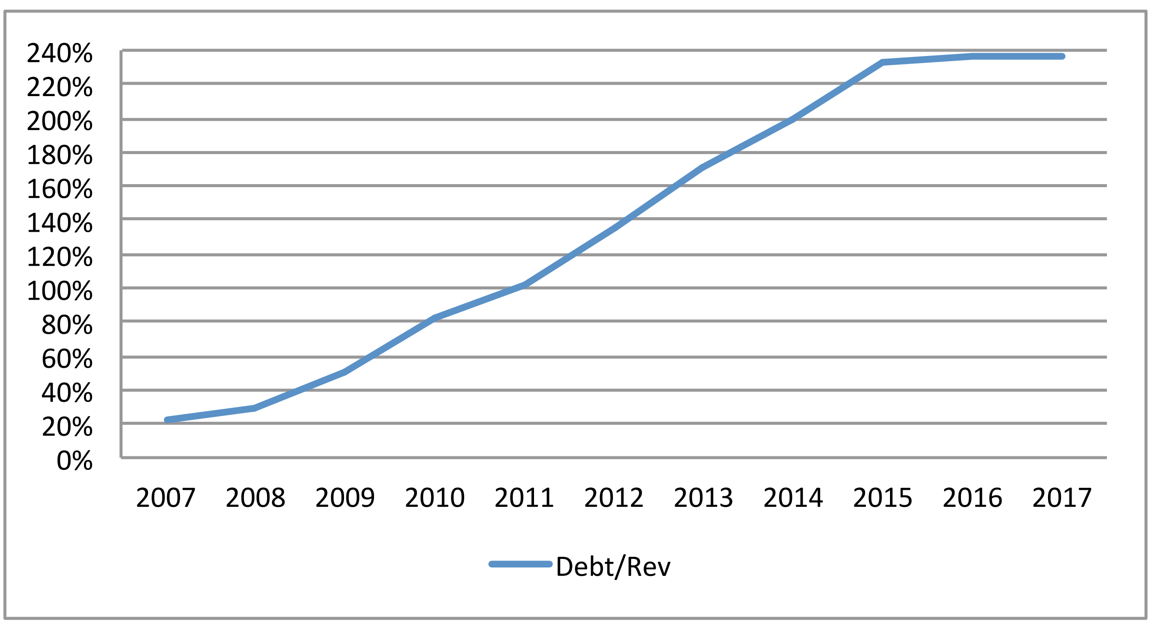


Chart 1b
Net debt to revenue ratio



And the figures in the charts relate only to central government debt. In addition to central government debts now approaching $2 1/2 billion, Government guarantees currently standing at nearly $700 million[1] have been issued for borrowing by other public and private sector undertakings – giving

[1] Though shortly to be reduced by $200m

total government exposure of around $3 billion. And public pension and government health insurance schemes potentially have unfunded liabilities of perhaps somewhere between $1.5 billion and $4 billion, representing a further potential future claim on government financial resources. We therefore continue to believe the Government is right to have committed to achieving budget balance (on the Government's preferred definition) by 2018/19, and thereafter to take further steps to reduce net debt.

7. In our report last year we:

- Endorsed the Government's aims of achieving a balanced budget in 2018/19; and over the longer term of meeting the targets set for the ratios of debt and debt service to revenue.

- Suggested that economic circumstances provided a window of opportunity for making relatively rapid progress towards these ends; and suggested that after achieving budget balance in 2018/19, the objective for debt and debt service ratios should be met within 5 years.

- Proposed measures to tighten fiscal policy by the equivalent of 2 1/2 % of GDP, on top of the already planned expenditure reductions of 2% of GDP. To allow for slippages we suggested raising revenues by the equivalent of 3% of GDP.

- We noted that to deliver the expenditure reductions built into the Government's plans will require structural reforms in the way that services are delivered, and we made some suggestions about the ways to go about prioritizing budget allocations.

- And we made a number of suggestions both for revenue measures that could be implemented quickly and for possible longer-term reforms in the tax structure.

We expressed the hope that this approach could gain at least a measure of broad support as a suitable fiscal aim for the island, noting that this will also be important for credibility and external confidence.

8. We also noted that with Bermuda facing a serious demographic challenge, additional actions were needed to address the likely increase in health care costs, rising costs of support for the elderly and the underfunding of pension schemes that will cause increasing problems over the long term. This would require early steps to adjust some of the terms and features of government pension and health insurance schemes to reduce their projected deficits. Alongside these changes we suggested that policy should be designed to meet an objective that net immigration of those of working age should be positive, significant and sustained by the end of the decade, and to encourage increases in the length of working lives.

9. In addition to these central recommendations, we made a number of detailed recommendations for consideration:

- The debt and debt service to revenue targets are the important ones for Bermuda, and we suggested dropping the target for debt to GDP.

- The longer-term rule of running a balanced current budget will also be useful once debt has been reduced to an acceptable level, although we suggested two minor modifications.

- Credibility would be further enhanced by action to limit future use of Government guarantees.

- It would help to establish a contingency reserve as a more efficient way to handle unexpected in-year spending pressures.

10. All these recommendations remain relevant and some of the most important ones have led to welcome proposals set out in the Government's 2016 Budget. The following section reviews these proposals and progress being made in implementation.

III. Government Actions Proposed and Taken over the Past Year

11. In its 2016 Budget the government reaffirmed the commitment to achieve a balanced budget by 2018/19, set out fiscal projections for the years ahead consistent with that aim, and reaffirmed its commitment over the longer term to meeting its targets for debt and debt service to revenue (while dropping the target for debt to GDP). These policy commitments are consistent with our analysis, although we continue to believe it would also be helpful to set out a longer-term timetable for meeting the debt and debt service to revenue targets. We also welcome the various measures announced in the budget to help deliver on these commitments, and to address some of the longer-term economic and fiscal challenges facing the territory. However, implementation is proving a challenge.

Expenditure Control

12. In our 2015 report we noted that achieving the programmed reductions in spending this year and in the years ahead would require reforms in the way that services are delivered and institutions structured, noting the SAGE Commission's findings (see Section VII below). We also suggested it would be important to demonstrate with visible actions that the Government is serious in its endeavour to increase efficiency and reduce waste alongside increases in taxes. But while the 2016 budget statement recognises the need for a revised approach to achieving expenditure savings, and a number of efficiency studies have been carried out, in practice action so far has largely been confined to across-the-board measures such as the continued hiring freeze, budget cutbacks to ministries, and measures to encourage early retirement by public servants. Additionally the Government has started a process of converting some departments into quangos. While this will not reduce the deficit in the short term it could help over time as quangos develop alternative sources of income. As discussed in section IV below, the proposed path for future spending reductions set out in the 2016 budget is less ambitious than the path set out in 2015. Even so, planned reductions may prove difficult to achieve with the approach followed so far reaching its limits of effectiveness. Containing expenditure in future will require a revised approach and more radical change in the way that services are delivered and departments structured as demographic change adds further pressures on the budget. Some of

the options are discussed in Section VII below.

Tax Measures

13. The 2016 Budget proposed a series of tax changes that would over time produce something like the 3% of GDP increase we suggested would be needed to meet the medium- term budget objectives. And the specific measures proposed all appear sensible in terms of their likely economic impact. Increases in the payroll tax and in customs and excise duties, and continued phasing out of payroll tax concessions were implemented in the current fiscal year. At the same time the government began consultations on the reform of the payroll tax and announced the intention to introduce a new General Services Tax (GST).

14. Good progress is being made on payroll tax reform; the objective is to introduce progressivity by shifting a larger share of the burden to higher earning employees, and to significantly increase the overall revenue raised. However, design of the new GST is taking longer than initially hoped. Progress in tax reform and some of the options for the future are discussed further in Section VII below.

Meeting the Demographic Challenge

15. The 2016 budget statement accepted the need for more young educated people in the island "to re-balance the current imbalance between retired seniors, who are major users of the health care system, and the younger healthier working population who are supplying funds, through their healthcare premiums, taxes and pension contributions." The statement also accepted that there was a need to update immigration policy with a start being made with the "Pathways to Status Initiative" that would provide for new pathways to permanent residency status in Bermuda for long-term residents. The legislation enacting this initiative met with strong opposition however and was withdrawn from the House of Assembly. Some of the issues are now being considered by a bipartisan Immigration Reform Working Group.

16. As elsewhere, immigration is a sensitive issue. But we hope that over time and with an informed public debate there will come to be a broader acceptance of the strong economic case for change, given the longer-term impact that Bermuda's changing demographics will have both on the potential for economic growth and the sustainability of Bermuda's social insurance fabric. Moreover, as a small economy based largely on international business and tourism, some emigration of talented young Bermudians cannot be avoided; there will simply not be the right opportunities for all. This means that in turn immigration is required to supply the skills and expertise necessary to staff these key industries, as well as to foster the emergence of innovative enterprises that can boost growth and employment as well as help diversify Bermuda's economy. There are some inescapable and difficult tradeoffs here. If Bermudians wish to preserve an open and prosperous economy, with a sustainable social welfare system – a model which has on the whole served the island well – then acceptance of a broadly open, growth-oriented immigration policy is likely to be a necessity.

Pensions and Healthcare

17. In 2016, there were four principal policy steps addressing pension and health concerns.

- First, in the sphere of pensions, the recent actuarial review of the **Contributory Pension Fund** (CPF) highlighted the continuing financial long-term challenges posed by adverse demographics and the effects of a weak economy on the contributor base (issues that are discussed more fully in section VIII and Annex B of this report). The Government responded quickly and appropriately in its decision to raise the benefit and contribution rates by 5% and 7.5%, respectively, the first such changes since August 2011. With the CPI increasing by 7.9 percent over the period, this implies some real decline in pension benefits.

- Second, in the 2016 Budget, the Government resumed its matching contributions to the **Public Service Superannuation Fund** (PSSF), which had been suspended in 2015/16. This was an action that we called for in our 2015 report, arguing that the suspension reduced the deficit only in an accounting rather than an economic sense, since it resulted in a corresponding rise in the underfunding of the PSSF.

- Third, the Government has recently established a Pension and Benefits Working Group (PBWG) to analyze the alternative scenarios included in the CPF report, with the objective of assessing what further steps might be needed to restore the financial sustainability of both the CPF and the PSSF and to tackle fiscal pressures emanating from the Government Employees Health Insurance Fund (GEHI). The PBWG's Policy Formation and Recommendation Notes highlight some constructive policy ideas. Some actions have already been taken and others are under consideration.

- Finally, in the sphere of health care policy, we applaud the Government's recognition of the need to redirect the focus of how health care is provided and accessed in Bermuda and, when necessary, overseas, and its efforts to realize greater efficiencies. Five recent policy actions should be noted. First, the recent announcement that the Government has been able to hold the line on the Standard Premium Rate while expanding the coverage of the Standard Health Benefit and strengthening preventive services is an important step. Second, in contrast, the Government increased the GEHI premium in order to reduce the deficit in its operations. Third, as a further means to control costs, the government has just announced that the Bermuda Health Council (hereafter referred to as the "Health Council") will be reviewing the fees for the Bermuda Hospital Board (BHB) with respect to diagnostic imaging and laboratory tests. Fourth, the Government has recently announced its long-term care action plan, which will reinforce efforts to facilitate healthy ageing in a home environment. Finally, the Government is now in the process of introducing legislation that would enable the Health Council to license health businesses. The Health Council believes this is an additional step supporting its ability to collect data on the quality of services and outcomes achieved to support patient safety.

IV. Near Term Fiscal Prospects: Achieving Balance by 2018/19

18. The fiscal outturn for 2015/16 was broadly similar to that set out in the 2015 Budget, with revenue and current spending both coming in somewhat above plans, more than offset by a shortfall in capital spending, so the overall deficit was about $7 million less than forecast (a relatively small deviation from plan). This contrasts with the previous year, when, as set out in our 2015 Report, there was a significant shortfall in revenue; this greater realism is welcome and suggests some improvements in budget planning and implementation.

19. This means that the current primary balance (that is, current revenues minus current spending, excluding interest payments and capital spending) was positive in 2015/16. The debt to revenue ratio is expected to fall very slightly over the course of this year. These are important milestones on the return to fiscal sustainability.

20. In the 2016 Budget, the Government reaffirmed its short-term target of budget balance by 2018/19, according to its preferred definition. This includes payments to the Sinking Fund, which would normally be treated as an intra-government transfer that does not increase the deficit; the government's target is therefore more ambitious than "budget balance" by the standard international definition, although possibly not very different from a target of current balance after allowing for capital depreciation (see Box 1).

Box 1

Deficit and debt service - definitions

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

Deficit

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

Current deficit

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

Debt service payments

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

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

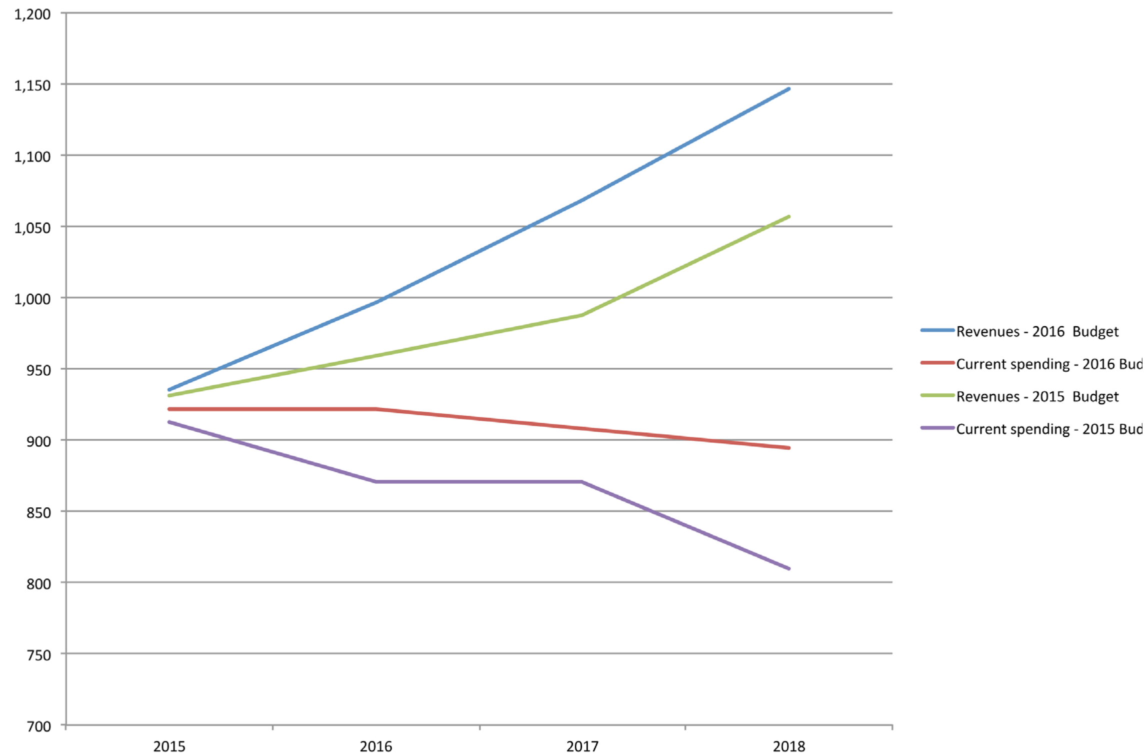
21. However, there have been significant changes to both the pace and the composition of the adjustment needed to achieve this target. As set out in our 2015 report, Government plans would have implied large spending cuts in 2016/17, and then a very sharp fiscal tightening, of about 2% of GDP, in 2018/19. This would have implied a rather uneven profile of deficit reduction and restrictions on spending which we judged implausible, absent fundamental structural reform that seemed unlikely in this timescale. Moreover, from an economic perspective there was no strong case for the implied very sharp tightening in 2018/19; nor were there, at that time, any specific policies in place designed to deliver it.

22. By contrast, the 2016 Budget sets out a path of adjustment that is both smoother and more balanced, with considerably more reliance on tax measures. This new path is shown in Chart 2. Spending in 2016/17 is planned to be roughly flat, while revenues increase by about 6%. Alongside a significant, one-off increase in capital expenditure, related to the America's Cup, this means that the deficit falls only slightly this year, although the underlying structural improvement is significant.

23. Deficit reduction is expected to then accelerate in 2017/18, with the planned introduction of a reformed payroll tax, and a modest reduction of spending (by about 2%). This means that 2017/18 sees a much sharper tightening of fiscal policy than previously planned. The 2015 Budget projected that the deficit would fall from about $150 million in 2016/17 to about $130 million in 2017/18 and then to zero the following year (although with no detail of how this final reduction was to be achieved). In contrast, the 2016 Budget now shows a fall from about $200 million in 2016/17 to less than $100 million in 2017/18, followed by a small surplus the following year. This was to be achieved entirely through increased taxes: in 2017/18, revenues were projected to be some $70 million higher than was forecast in the 2015 Budget, largely as a result of payroll tax reform, with the introduction of GST then contributing to the move to a surplus the following year.

24. We judge this rebalancing and reprofiling to be appropriate, and consistent with the recommendations made in our 2015 Report. In particular, the objective of implementing a structural increase in tax revenues of 2 ½ to 3 percent of GDP over the next 2 years, through a combination of increases in and reform of existing taxes and the introduction of the GST, while continuing to control spending, closely reflects our recommendations. The key challenge for the government is now implementation, and in particular a successful implementation of payroll tax reform, the introduction of the GST as quickly as possible, and with additional revenue-raising measures to compensate for any delays in introduction or shortfalls in proceeds It also requires continued tight control of spending: while the relaxation of spending cuts compared to the 2015 Budget was probably appropriate – given our judgement that, absent more fundamental reform, they were unlikely to be achievable – it would not be sensible to allow any further slippage and it has become urgent to begin to implement more structural changes in the way that public services are delivered.

Chart 2
Short term spending and revenue projections



V. Economic Developments and Prospects

Global Context

25. Global growth remains subdued, with the IMF again reducing its forecasts for growth in both 2016 and 2017. Of particular concern to Bermuda, the most important downward revisions were for the US, which is now projected to grow only 1.8% this year and next. The US election has increased uncertainty, and in particular has already led to a significant rise in long-term interest rates, as well as expectations for relatively rapid rises in short-term rates over the next year. These will, over time, translate directly into increased borrowing costs for both the private sector and the government.

Bermuda's economic prospects

26. The Bermuda economy returned to growth in 2015, with real GDP rising by 0.6%. While this is relatively sluggish, growth was reasonably broad based, reflecting increases in activity not just in international business, but also in wholesale and retail trade, and hotels and restaurants, reflecting a much improved performance in the tourism sector. Nominal GDP – which is what matters from the perspective of fiscal sustainability – grew by 4 percent, exactly in line with our projection last year for the trend rate of growth.

27. Unemployment fell significantly to 7%; however, so did employment, as falling numbers of public sector employees were not offset by any significant increase in private sector employment. So although the fall in unemployment is obviously positive from a social perspective, it did not in itself translate directly into growth. More broadly, the fact that unemployment can fall sharply without a corresponding increase in the number of people in work reflects Bermuda's challenging demographics, and, as noted elsewhere in this report, poses serious challenges to long-run sustainability.

28. GDP in the second quarter of 2016/17 rose by 1.3% compared to the previous year (after a fall of 0.6% in the first quarter). Household consumption remains relatively subdued, while capital formation (especially construction) is healthy, perhaps indicating that some large construction projects are now coming online. The tourism sector, in particular, is performing well. In the near term, Bermuda should see reasonably healthy growth (by recent standards) boosted by major construction projects and the America's Cup. Independent analysts (Moody's and Standard & Poor's) estimate that real GDP is likely to rise by 2-3 percent a year in 2016 and 2017. This will both automatically improve the fiscal position, and should ease the direct economic impact of the sharp fiscal tightening planned in 2017/18. Indeed, the economy should be in a better position to cope with a significant increase in the tax burden in 2017-18 than it has been for a considerable time.

29. However, the medium-term challenges remain as we set out last year; translating the recent increase in tourist arrivals, and the boost from the Americas Cup and large construction projects into a sustainable increase in high-value tourism; and maintaining the competitiveness of Bermuda's international business sector. On the former, the jury remains out: there is recent but convincing evidence that Bermuda is broadening and deepening its appeal in what is an extremely competitive market. On the latter, Bermuda has done extremely well to preserve its competitive edge despite being a comparatively high-cost jurisdiction. But as discussed above there are some risks ahead which could do serious damage to Bermuda's financial sector.

30. One question that might reasonably be asked is – does Bermuda actually need economic growth? It is, after all, in per capita terms already one of the richest places in the world, comparable to Monaco, Luxembourg or Liechtenstein, and with an extremely high quality of life. If the measures necessary to boost growth - such as, for example, higher immigration – are perceived by some Bermudians as threatening this quality of life, perhaps they would be best avoided. Maybe the government should concentrate on ensuring that all its citizens benefit from this prosperity, and worry less about future growth?

31. The problem is that, as the analysis elsewhere in this report shows, such a strategy would quickly become unsustainable. Bermuda's demographics mean that without growth not only is there a risk that the public debt would quickly become unsustainable, but that Bermuda's generous – and expensive – health and pension provisions would be unaffordable. Economic stagnation would, over time, have a significant negative impact on the welfare of most Bermudians, especially the poorest, the elderly, and those in poor health.

32. Generating the growth Bermuda requires to address the needs of an ageing population is unlikely to be feasible with a shrinking workforce. But on present trends this is precisely what is likely to happen; it can only be prevented by some combination of longer working lives and greater net immigration of skilled people of working age.

VI. Debt targets

33. In our 2015 report, we illustrated three potential scenarios for the evolution of Bermuda's debt burden:

- In the first, "budget balance" scenario, we assumed that the government proceeded in line with the policy then set out, of achieving budget balance through spending cuts, and then maintained balance. As noted above, we did not regard this policy as either feasible or desirable. We estimated then that it would have meant that achievement of the key debt/revenue target would not be met until 2034.

- In the second, "incremental" scenario, of slower but still spending-based adjustment, the debt/revenue target would not be hit until 2041.

- Under our preferred scenario, however, of "aggressive fiscal consolidation," to be achieved primarily by increases in revenue, we projected that the debt/revenue target could be achieved by 2023/24, five years after the budget was balanced.

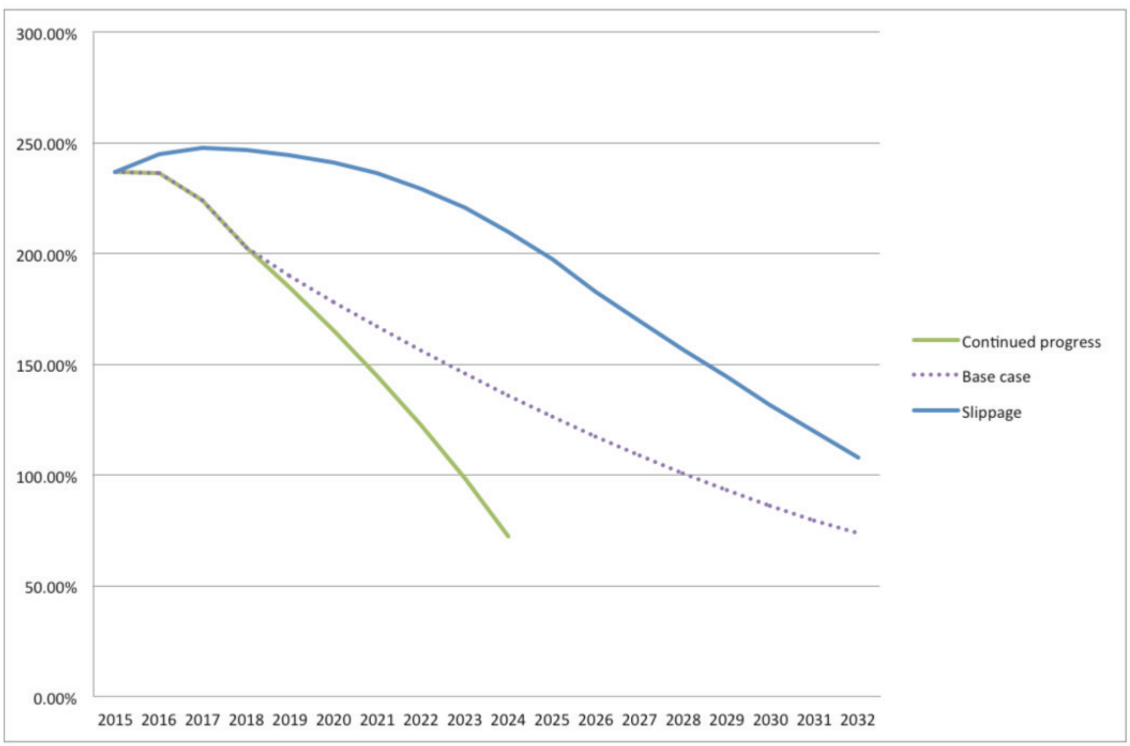
34. We have updated these projections to account for developments in government spending and revenue since last year, and to government policy. Again, we illustrate three potential scenarios (see Chart 3):

- In the first, which we regard as a ***"base case"*** scenario, we assume that the government does achieve budget balance in 2018-19 as set out in the 2016 Budget. Thereafter, we assume that nominal GDP grows at 3.5% (comprised of 2% inflation and 1.5% real growth); given Bermuda's demographics, trend growth of more than this seems implausible). We assume that after 2018-19 revenues grow at 3.5% nominal, while current spending grows at 4.5% nominal; the faster growth of the latter reflects the expected impact of population ageing (see Section VIII). Since revenues will by then exceed current spending by a significant margin, and debt interest costs will be shrinking in relative terms, the impact of this in practice is that the surplus stabilises at about $20m. This scenario would allow the debt/revenue target to be achieved by 2031-32. This scenario, then, envisages somewhat faster fiscal consolidation than implied by last year's plans, although it remains considerably slower than the strategy we recommended.

- As noted above, the key task for the government in the short term is to deliver on the plans set out in the 2016 Budget, in particular the successful implementation of payroll tax reform and the GST, as well as continued spending restraint. Recent experience suggests that the latter will be challenging; GST implementation seems likely to slip or to produce less revenue than hoped. In order to illustrate the risks here and the impact of any potential slippage, we illustrate a ***"slippage"*** scenario. Under this, we assume that after being roughly flat between 2015-16 and 2016-17, spending grows at 2% a year thereafter, instead of resuming its fall as the Budget suggests: and that revenues grow at only 4% per year, only marginally faster than nominal GDP, rather than the 6-7% planned. Under this scenario, the deficit continues to fall, but more slowly and budget balance is delayed by eight years, until 2026-27. After that we assume that, as in the base case, spending and revenues grow in line with nominal GDP. The debt to revenue target is then achieved in 2035-36. While the precise numbers used for these projections are purely illustrative, this scenario illustrates the importance of implementation of both revenue and spending plans in the short term.

- Finally, we illustrate a ***"continued progress"*** scenario. This assumes that the short-term fiscal plan is implemented successfully, resulting in budget balance by 2018-19. However, thereafter, instead of simply allowing both spending and revenue to grow in line with nominal GDP, spending is constrained to grow at 3%, slightly slower than GDP, while revenues grow faster, at 5%. Although this may seem like a fairly modest additional adjustment, the impact of compounding is significant. This allows the debt-to-revenue target to be achieved three years earlier than in the base case, by 2024-25, with revenues $160 million higher, and spending $100 million lower, than in the base case.

Chart 3
Debt to revenue ratio under alternative scenarios



35. In our view, this last scenario would represent an appropriate overall strategy. It does not require more aggressive fiscal consolidation than set out in the 2016 Budget. However it does crucially require:

- First, that the short-term targets set out in the Budget are delivered. This means that shortfalls in tax revenue, resulting from delays in the implementation of the GST or otherwise, must be filled from other tax changes.

- Second, continued tight control of spending in the short term, with any overshoots compensated for by cuts elsewhere.

- Third, a longer-term strategy for improving the efficiency of government spending remains imperative. The incremental strategy of across-the-board cuts and freezes has probably already reached its limits of effectiveness.

- Fourth, addressing the implications of demographic change, discussed below, will also require some reconsideration of the role of government's provision of income support, whether through its pension and health care policies for its employees or the scale of its subsidies in the sphere of health care.

- And finally, it requires a consensus that fiscal discipline needs to be maintained for the long term. It will not be enough to simply balance the budget, declare "job done" and then return to old habits of lax spending control and insufficient attention to maintaining and expanding the tax base.

VII. Tax Reform and Improving the Efficiency of Public Expenditure

Tax Reform

36. Consultations on the details of the proposed payroll tax reform have been proceeding; we understand that the reformed tax will be ready for implementation from April 2017. The objective is that it should contribute a large part of the $150m increase (over the current fiscal year) in revenues needed by 2018/19 to meet the aim of a balanced budget in that year. This is likely to be delivered by increasing the tax paid by higher income employees (and making it mandatory that employees pay their portion directly). This will mean the system becomes progressive (the burden on lower paid employees is likely to fall). While desirable from an equity perspective, there are risks associated with putting too large a burden of adjustment on the internationally mobile business sector, which accounts for the largest share of high income employees. It will be important to ensure that the self-employed and service providers in limited partnerships also pay in relation to their actual income.

37. Meanwhile, consultations on the new GST have been delayed and there is no prospect of it being implemented before 2018/19 at the earliest. In the 2016 Budget forecast it was assumed that GST when implemented would contribute approximately $50m a year. Our judgment is that there must be a risk that payroll tax reform will not yield the full amounts of revenue required by current government projections, given the scale of the increases projected and the likely pressure for exemptions or for transitional provisions for some sectors. And there is a potentially even larger risk that the GST will be further delayed or that the proceeds will be less than hoped.

38. It therefore seems possible that, absent additional action, government will face a revenue shortfall in 2018/19 and will need to consider other options for tax increases or spending reductions if, as we recommend, the aim of a balanced budget is to be met. It would be sensible to do some contingency planning for such an eventuality.

39. Possible alternative sources of extra revenue include the following:

- Adjusting the land tax. In the 2016 budget, changes in land taxation were designed to be revenue neutral, but average land taxes are low compared to the US, for example, and ways could be found to shield those who genuinely cannot afford to pay from any increase. Land taxes have both economic and social advantages; since land is immobile, the potential negative impact on the tax base is much smaller than with taxes on income or consumption. And since land ownership is of course strongly correlated with wealth, increases – if structured appropriately – will bear most heavily on those who can afford to pay.

- Further increases in staff resources devoted to tax enforcement.

- Increases in tourism-related taxes, such as the cruise passenger and cabin tax, or the imposition of the equivalent of the hotel tax on holiday rentals.

- An increase in annual registration fees for "exempted" companies could prove a source of extra revenue. This could be in the form of a graduated charge, with larger companies (as measured by profits or turnover) paying more.

- A further option, which we mentioned last year, would be to begin to phase out the tax concession for electricity generation (to BELCO), which is in effect a form of subsidy for energy generation from hydrocarbons, discouraging development of solar and other renewable sources of energy supply. The continuing low oil price provides a window of opportunity for such action. Even so such a change might need to be implemented gradually given the impact on household energy costs and so might only make a modest contribution in 2018/19.

40. More generally, we see a very strong case for further expanding the administrative capacity of the Tax Commissioner (and tax-related functions in the Ministry of Finance). Delivering a full reform and restructuring of the payroll tax system; designing and implementing an entirely new GST; and considering further options for broadening the tax base and increasing revenue represent an exceptionally demanding and challenging agenda. In our view, current staff resources will not yield the capacity required. It was clear to us that the Tax Commissioner does not have the capacity to begin serious work on the GST until the payroll tax reform has been successfully implemented. Extra resources would almost certainly far more than pay for themselves; just one month's delay in implementing the GST, for example, leaves a $4 million hole in the government's finances. And as noted, extra resources devoted to tax enforcement could produce a significant return in improved compliance.

Improving the Efficiency of Public Expenditure

41. In our 2015 report we stressed the importance of achieving meaningful improvements in the current expenditure budget, in a way that goes beyond non-targeted, across-the-board cutbacks or hiring freezes. The Government's SAGE Commission initiative suggested ways to consolidate departments, cut the size of the legislature, privatize some government activities and achieve greater efficiencies through outsourcing. The Commission's report highlighted weaknesses and inefficiencies in service delivery in the transport, waste disposal and public works sectors. Last year, we were given to understand that the Government was prioritizing the Commission's recommendations in terms of the timing and effects on the budget and efficiency. While there have been a number of efficiency studies, actions so far have largely been confined to a continued hiring freeze, across-the-board spending cuts and encouragement for early retirement for public employees. There are also plans to convert more Government Departments into quangos. While this will not reduce the deficit in the short term, it could help over time as the new quangos develop alternative sources of income. As we noted last year while the proposed new airport project does not involve public spending, the resulting revenue loss, net of cost savings, will need to be offset by other fiscal measures. So decisions on the airport will need to continue to take account of these opportunity costs to the budget, weighing these costs against the benefits of the project.

42. We again underscore the vital importance of efforts to prioritize government budgetary allocations and address inefficiencies and to demonstrate the Government's commitment to improve efficiency and reduce waste. We recognize that such policy reforms take time to implement, given the manpower changes that are involved and the political sensitivity of reform (in the words of the late President Mitterand, "You need to give time the time to do its work!"). But as discussed in the following section savings will be needed in the medium term even more than in the short term given the extra spending pressures to come from demographic change.

43. Last year, we indicated three critical steps to further this agenda and given the apparently slow progress over the last year we are repeating the same points this year.

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

- Second, assess whether there are areas of government business where some increased employment or improvement in current procedures or organizational structure might have a payoff in higher economic growth or government revenues. In last year's report we mentioned the potential payoff from a reorganization of the administration for tax (and health insurance premium) collection and from increased resources for tourism marketing and development, and we welcome the increased resources made available for these purposes in the 2016 Budget. The BTA, in particular, appears to have deployed these resources very effectively.

- Third, identify areas where privatization of government assets or outsourcing of service delivery could improve efficiency

44. We should also note that this is not just about realizing budgetary savings. Improving the efficiency of service delivery will have two further benefits. First, to the extent that slow or inefficient government administration (for example, in processing construction or vehicle permits) is a constraint on new business investment, quicker and better administration will help boost economic growth. Second, visible improvements in the quality and efficiency of government service provision will make increases in the tax burden more politically acceptable and visibly equitable from the perspective of the private sector and the business community.

VIII. Addressing the Challenge of an Ageing Population

45. The case for fiscal adjustment to reduce Bermuda's outstanding public debt only in part derives from the need to create fiscal space for needed investments and to reduce vulnerability to potential external shocks. Two other risks underline the need for additional fiscal space. First, on current trends, by 2030, Bermuda's low fertility rate and rising life expectancy will lead to a very large increase in the share of its elderly population, creating significant fiscal pressures from pensions and health and long-term care. Second, these pressures may be heightened if the low-interest rate environment that has characterized financial markets over the last decade is increasingly the norm rather than an anomaly. Low interest rates would alter the assumptions underlying the actuarial calculations on the costs and returns of the various pillars of Bermuda's public and private pension schemes. Together, the implications of these trends are several.

46. In the sphere of **health care**, Bermuda is one of the highest cost health care systems in the world, and is an outlier compared to other island economies. More than a third of these costs are already attributable to the elderly and these costs might rise further as the elderly are more at risk from multiple chronic health conditions. This will strain a policy framework that has sought to moderate the cost borne by the elderly by shifting some of the cost on to the general taxpayer. As shown in Annex B, *under current policies for aged subsidies*, an increased elderly share would double aged subsidies from the general budget by 2034 from its 2014 level of $70 million. The Government recognizes this problem and intends, as reflected in its *Bermuda Health Strategy 2014-2019*, to cap these subsidies and develop, over time, policy mechanisms that target these subsidies to the most needy. Given the time it would take to implement such an approach, it would be urgent to begin now to develop the modalities for such targeting.

47. Future Care, an optional supplementary health insurance program for the elderly, has sought to save costs by shifting the focus of long-term care towards the home and away from a hospital setting. But presently, roughly 40 percent of those Bermuda's seniors not covered by their previous employer's health insurance plans do not avail themselves of Future Care coverage, presumably in part because of its higher premium. If Future Care fails to cover all the elderly, this can only lead to much higher costs for the health care system as a whole. This again raises the question of how to finance more universal coverage for this group, an issue that will become more pressing over the next decade. A further problem that could become serious within a decade is that Future Care does not adequately address the challenges that will arise from a significant share of the elderly likely to be afflicted from various forms of dementia. The Government recognizes the potential financial pressures that this could create and has begun a process (under its recently issued *Long Term Care Action Plan 2016*) to develop, over the next

several years, proposals that could possibly entail a pre-payment mechanism for long-term care insurance (see Annex B, para. 14).

48. We recognize that the Government, through the Ministry of Health and Seniors, and the Bermuda Health Council, is pursuing reforms to increase the efficiency of the health care system, ensure that appropriate technologies are available to meet the needs of Bermuda's population and improve its health status. These efforts will only become more difficult with the increased sophistication and cost of available medical technologies. Health care financing touches every aspect of Bermuda's economy, affecting the cost of labour to employers, weighing on the incomes of its citizens, and burdening the Government's budget, both as an employer and as the provider of services and subsidies for children and elderly. As in other advanced countries, achieving greater effectiveness in health spending may require a transition from a fee-for-service reimbursement system to a value-based reimbursement system based on outcomes and the quality of care.

49. In the **pensions** sphere, our 2015 report highlighted that the Government has unfunded pension liabilities in relation to its employees of more than $800 million. The recent actuarial report on the CPF suggests additional unfunded liabilities ranging from $500 million to $3.3 billion, depending on the assumptions made (including the possibility of lower interest rates). A realistic alternative more adverse real rate of return assumption than assumed by the actuaries would imply that the CPF's unfunded financial liabilities are even larger. Beyond the effects on the adequacy of the funding of the CPF, a low interest rate environment could create contingent fiscal risks if poor private pension outcomes affect a significant share of Bermuda's elderly.

50. The policy options available to the Government require a difficult but urgent policy conversation with Bermuda's citizens. The financial viability of public and private sector pension schemes and the Government's budget would all benefit by accelerated introduction of a higher retirement age, coupled with actuarial-based penalties for early retirement. At a minimum, this would suggest that the retirement age for the PSSF should be increased to 65 and even ambitiously to 67 over the next 5-10 years; that for the CPF should be raised to 67 over a five-year period. Many high-income countries have begun the practice of adjusting the retirement age to improvements in life expectancy.[2] Private occupational pension funds would also benefit from a phasing-in of higher retirement ages, increasing the period over which savings are built up for retirement and reducing the period over which pensions are the principal source of retirement income, while at the same time contributing to a needed increase in the working population.

51. Any adjustment to the retirement age should be implemented gradually, both to accommodate the understandable resistance of those close to retirement age and to foster initiatives by Bermuda's society to accommodate more elderly in the labour market. Such policy reforms are being introduced in almost all industrial countries, albeit with varying degrees of success in terms of the pace of absorption of elderly workers in the labour market.

52. Extending working lives would have a triple benefit. It would improve the fiscal position

[2] Examples include Denmark, Finland, Norway, Portugal, Sweden and the United Kingdom.

through reductions in pension expenditures and in the subsidy for health provision for those over pension age. It would increase tax revenues. And it would improve both the pre and post-retirement incomes of those approaching pension age. But these effects cannot be realized simply by increasing the state pension age. It will require a concerted effort by government and the private sector to change social attitudes to working longer. Extending working lives and increased net immigration (discussed in paragraph 16 above) are essential complements: neither on its own will be sufficient.

53. More generally we see the need to take a more integrated look at the linkages between pensions, health insurance and long term care, and the needs of a growing group of less well-off seniors. For example, measures to contain health care cost pressures will also help sustain the adequacy of pensions. For this and other long-term policy analyses, Bermuda requires an improved database. Completion of the 2015 Census needs to be followed quickly by richer demographic forecasts through to 2040 in order to provide a clearer picture of the population's age structure, particularly among the elderly.

54. Finally, to ensure that Bermuda's growth is socially sustainable, there needs to be a clearer analysis of the position of different income groups taking into account pension contributions, future health care premiums, and health care co-payments. From a social sustainability perspective, the economic position of Bermuda's elderly population a decade from now is unclear. The CPF pension benefit is already below the poverty line and looking forward may be increasingly inadequate to support those elderly for whom it is the principal income source. How will those who are wholly dependent on CPF benefits and possibly limited private occupational pensions manage to finance the cost of possibly higher health care premiums (with a reduced aged subsidy) and increased co-payments? Will even more of Bermuda's elderly decide not to be insured under the Health Insurance Plan or Future Care, thrusting the financial burden of their care on to the hospital system and undermining efforts that promote proactive management of chronic illnesses? Does this argue for change in the current policies for financial assistance to the elderly, and if so how could such a policy shift be financed? These questions raise issues of distributional equity, but cannot be avoided in any discussion of future budget priorities.

IX. Conclusions

55. The risks and uncertainties facing Bermuda's economy in both the short and longer term are greater than they were a year ago, with Brexit, the US election outcome, and the impending evaluation of the island's anti-money laundering/counter-terrorism financing regime all presenting potential new challenges. The current high level of government debt – combined with very large potential liabilities from government guarantees and underfunded public pension and health insurance schemes – means that any negative shock resulting from these or other factors, internal or external, could have very serious economic consequences. Reducing government debt and debt service costs must therefore remain an overriding priority.

56. We therefore welcome the proposals set out in the Government's 2016 Budget for achieving budget balance by 2018/19. The scale of the proposed increase in revenues and the detailed tax proposals are very much in line with the suggestions we made in our report last year. We also

share the view that reducing expenditure will require a radical and structural approach. And we welcome the initial steps taken to address underfunding of public pension schemes and to control health care costs.

57. The challenge now is implementation.

- Neither payroll tax reform nor designing a new services tax will be easy. We see an urgent need for extra resources in the Office of the Tax Commissioner and in the Finance Ministry, and even with such extra resources there is the risk of delays in implementation or that the proceeds, especially from the services tax, will be less than hoped for. It would be wise to consider contingency plans for alternative sources of extra revenue if needed.

- On expenditure, delivering significant further reductions requires structural change in the way services are delivered. While such changes may take time to implement, given the likely scale of longer term cost pressures on the budget, a start needs to be made now.

58. For the longer term we would also like to see:

- A target timetable set for meeting the longer-term debt and debt service objectives.

- Measures to address the unfunded liabilities of public pensions and health insurance schemes, probably through a combination of increases in contributions and changes in the terms of these schemes.

- Continued work on the range of measures needed to contain rising pressures on the budget from the social and health care needs of an increasingly aged population. These will include new approaches to service delivery and better targeting of assistance.

59. Beyond fiscal measures, Bermuda will need to begin adjusting to the expected rise in the share of the elderly and decline in the working age population. Without change, it will simply not be possible to finance the required levels of social provision from a shrinking economic base. Policy measures are needed to encourage longer working lives, including phased, pre-announced increases in the retirement age. A constructive social dialogue will be needed on how to respond to the challenges of the poor health of many of Bermuda's elderly. And finally, a broader, more strategic approach is needed on immigration policy, aimed at positive net immigration of people of working age, especially those that bring the skills needed for the new businesses the economy needs. We hope that a period of public discussion and debate will lead to a wider acceptance of the importance of the role of immigration, including the return of Bermudians who have left in recent years, in fostering the health of the island's economy and the continued viability of Bermuda's social insurance arrangements.

60. As we said in our report last year, we hope that this balanced set of measures to address Bermuda's fiscal, debt and longer-term demographic issues could over time gain a measure of broad support from all those who live on the island.

61. We look forward to making a further assessment in a year's time.

Annex A: List of Meetings Held by the Panel (November 14-18, 2016)

Association of Bermuda Insurers and Reinsurers

Bermuda Bankers Association

Bermuda Chamber of Commerce

Bermuda Health Council

Bermuda Hospitals Board

Bermuda Monetary Authority

Bermuda Pension Commission

Bermuda Tourism Authority

Bermuda Trade Union Congress

The Honourable Walton Brown, Shadow Spokesperson for Immigration

The Honourable David Burt, Opposition Leader and Shadow Finance Minister

Nathan Kowalski, Anchor Asset Management

KPMG Consultants

Cheryl Lister, Consultant to the Government on AML/CTF

Ministry of Health and Seniors

Ministry of Finance

Minister of Home Affairs

Office of the Tax Commissioner

Peter Everson (PE Consultants)

Robert Stubbs (G-MASS)

Craig Simmons (Bermuda College)

Annex B: Longer Term Challenges and Actions Needed

1. In our report, we emphasize two important policy challenges that Bermuda must confront. The first is to ensure *fiscal sustainability*—to provide sufficient fiscal room to respond both to the pressures of demographic change and other challenges to growth and macroeconomic stability. The second is the risk of *social unsustainability* if many elderly are poor and cannot finance their health care needs. This Annex elaborates on these issues.

a. Demographics

2. The Government's population forecasts extend only through 2020, with the results of the 2015 census not expected to yield longer-term forecasts until 2018. This hampers the Government's capacity to assess the cost of age-sensitive policies related to the share of the very elderly in the population (notably, aged subsidies and Future Care). Morneau-Shepell's actuarial review of the CPF's financial position in 2014 provides a picture of the demographic change facing Bermuda. Under the assumptions of no net migration and some small increase in life expectancy, the period through 2034 will see an increasingly older population structure. The old age-support ratio, which roughly measures how many of working age provide support to each elderly person[3], was 3.9 in 2014. It is projected to fall to 3.1 in 2019, 2.4 in 2024, and 1.9 in 2029. The rate of decline then decelerates, falling to 1.6 in 2034 and ultimately stabilizing at 1.3 during 2044-2057. So the next 15 years will profoundly upend the assumption of social solidarity in the financing of the CPF as well as other forms of elderly support for health care. Immigration reform could moderate some of the costs of demographic change but only to a limited degree.

3. While there is no official forecast of the share of the very elderly (however defined, whether 75+, 80+ or 85+) a doubling in this group by 2034 is almost certain. Realistically, looking at the UN's 2015 demographic projections for high-income countries, the share of the very elderly will probably increase even faster, perhaps by a third more. This would incrementally further increase the potential cost, under current policies, of aged subsidies. Even this increase might prove optimistic if one considers "longevity risk," viz., that Bermuda's elderly might live two or three years longer than predicted by actuaries.[4] In contrast, the share of the under-19 population is projected to decline, yielding some potential fiscal savings on educational spending. But note, between 2014 and 2034, the 65+ group will rise by 10,000 while the under 20 group will fall by only 1600.

b. Pensions

4. Bermuda's leaders are well aware of these demographic trends and can be commended, both for detailed assessments of their consequences and for some (though not all) necessary policy adjustments in public pension schemes. But our concerns about both demographics and interest rates have important potential fiscal implications for each of the three major pillars of Bermuda's

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[3] The old-age support ratio is the ratio of the population between ages 20-64 to the population 65 and over.

[4] The April 2012 IMF *Global Stability Report* (chapter 4) on "The Financial Impact of Longevity Risk" highlights how costly even a three-year underestimation of longevity at retirement can prove to government pension and health insurance schemes.

pension framework—the CPF, the PSSF, and the network of private occupational pension funds.

i. The Contributory Pension Fund

5. The 2014 actuarial review indicated that the CPF's financial performance was improved since the last review, allowing a slight rise in its asset-expenditure ratio. This compares favourably among a sample of other regional social security schemes, despite the 3 percent expected fall in the contributor base. Under the best estimate scenario, the CPF's assets should now last until 2049, two years later than previously expected.

6. Nevertheless, CPF's actuaries still recommend that contributions increase faster than benefits, with the target benefit/contribution ratio hitting 2.5 in 2030 and falling further to 1.42 (in 2064) (relative to a current ratio of 3.5). The actuaries also highlight that the CPF is not sustainable over the long term unless the contribution rate increases even more rapidly and the Fund earns at least 4% through the projection period. What could improve the position would be "an increase in the retirement age to 67 over a five year period ending 2023, all else unchanged…[This] could … result in a sustainable Fund over the projection period."

7. We would highlight two important implications of this review. First, the actuaries' best estimate scenario assumes a real rate of return of 3.5% throughout the projection period. It does offer scenarios where the real rate of return is 2%, in which case the CPF's reserves are depleted in 2041, eight years earlier than under the best estimate scenario. A plausible adverse assumption would be a real return even lower than 2%. This would deplete the CPF's reserves even faster. While the Government is not legally obliged to cover any CPF shortfall there would be strong political pressures to do so.

8. Second, the increasingly higher flat monthly contribution rate that is recommended is regressive. While all contributors will receive CPF benefits, the CPF's role as the first-level source of old age financial support is particularly critical for those that have not complied with the mandate to contribute to the National Pension Scheme. This is particularly an issue for many self-employed. For such workers, the CPF offers a pension of $16,800, less in real terms than in 2014. From this amount, a pensioner subscribing to Future Care would have to pay premiums of $6000, yielding a net income of no more than $10,800. The poverty line for a single person in Bermuda was established in 2008 as $27,000. Looking forward, this raises the concern that the CPF may be increasingly inadequate for those elderly at the bottom of the income pyramid.

ii. The Public Sector Superannuation Fund

9. The Policy Formation and Recommendation Notes of the PBWG highlight the need to strengthen the PSSF's financial position. There was already a suspension of the COLA adjustment factor in 2015. These Notes also suggest the group will consider, inter alia, policy reforms that would raise the age for receipt of unreduced pensions from age 60 to 65; actuarially reduce pensions associated with early retirement prior to 65; decrease the pension accrual rate from 1.5 percent to a lower rate; shift to a final 5-years average salary; and/or convert the scheme to a DC scheme. Such recommendations are consistent with those in the SAGE Commission Report and worth

more detailed consideration. Consideration could also be given to a gradual increase to 68 in the age for receipt of unreduced pensions.

iii. Private Occupational Pension Funds

10. The current low interest rate environment has increasingly been the focus of concern for occupational pension plans in many industrial countries, whether reliant on defined benefit (DB) or defined contribution (DC) pension schemes. There are two points that should be of concern to the Government. First, for the limited number of DB schemes that are still active, companies may find it challenging to maintain such schemes, as the net present value of their pension liabilities is now higher as a consequence of a lower market discount rate. This may force them to set aside additional funds to meet their pension obligations or to convert (as has been the case for those DB schemes that were frozen) to a DC scheme, possibly yielding much lower pensions than had been previously envisaged.

11. Most private pension plans have been established under the National Pension Scheme (since 2000) and involve roughly matching contributions by employers and employees (for a total of 10%). In such schemes, the risks of low market returns are borne by the worker. When the NPS was established, it envisaged that the schemes would yield a pension equivalent to a 70% replacement rate. Given the conservative investment practices observed in a substantial share of these plans, the high administrative and investment management fees charged in these plans, and the low interest rates that have prevailed in the last few years, there is a concern that these schemes will now yield a much lower replacement rate in the future. If the current low interest rate environment is the "new normal," the inadequacy of the assets accumulated under the schemes may be followed by a low annuity pay-out. Such developments could add to the number of elderly in financial difficulty. The Government would be well advised to undertake a detailed actuarial analysis of the investment performance of the private pension schemes in Bermuda, the prospective replacement rates that are implied, the quality of their observed governance, and the adequacy of the annuity schemes that are now available. Given the aging of Bermuda's work force and the critical role that these pensions will play in retirement, such an analysis would shed light as to whether the pension contribution rates are adequate and whether reforms might be needed in the governance of these schemes.

c. Health and Long-Term Care

12. A significant share of Bermuda's health care costs is attributable to its elderly. According to an estimate by the Health Council, more than a third of health costs are attributable to the 13.6 percent of the population aged 65+ and the rising share of the elderly will only add to the demand for medical care. The financial assumptions underlying the Standard Health Benefit and the Standard Premium Rate underlying Bermuda's health insurance system are predicated on a current policy of providing subsidies for health care to the elderly. Specifically, as of fiscal year 2015, the local government claims subsidy is 70% for those aged 65-74 and 80% for those aged 75 and over (reduced from 80% and 90%, respectively).

13. A review of the per-capita claim costs of different age groups on the health insurance system (see Appendix 1 of the 2015 Actuarial Report of the Health Council) shows the impact of the aged subsidy. Claims per capita on the insurance system steadily rise through age 64 (from $2,700 for those aged 45-54 to $4,000-$4,500 for those aged 55-64) and then fall to roughly $2,000 for those over age 65. Thus, the aged subsidy reduces what would otherwise be financed from the Standard Premium Rate.[5] The implication is that, under current policies, as the population share of the elderly begins to increase, a higher level of health care costs would have to be financed, assuming that the current subsidization rate is maintained (see Box 2). This suggests the financial pressures on the health care system engendered by population ageing and the challenge of determining how these costs will be financed. The Government's plan to cap these subsidies is a necessary first step but it will require a strategy for targeting the limited available assistance to the most needy elderly.

14. Section VIII noted two key issues involving Future Care: first, that many elderly may be unable to afford the additional premium for Future Care. Second, while Future Care encourages personal home care services, it explicitly excludes long-term custodial care in a nursing home, raising the question of how to finance long-term care for those afflicted with dementia. Already, there is a severe shortage of available nursing home beds in Bermuda and this will only become more pressing looking forward. Finding available carers to service this population will also be necessary. Caring for such individuals at the BHB is an unacceptably high cost option. The initiative to launch an action plan in the next year to develop a 3-5 year strategy for addressing how to finance the cost of caring for this group is a welcome first step. But it will importantly require a conversation within society on how to address this challenging social and economic policy issue over the long term.

[5] Nominally, these subsidies are presumed capped in the annual budget, but if the amount of subsidies that would need to be paid exceeds the budget estimate, the costs to be subsidized would ultimately be financed either by the Budget or require transfers from other parts of the health care system (e.g., the BHB or the Mutual Reinsurance Fund).

Box 2: Gauging the Impact of Bermuda's Ageing Population on the Aged Subsidy

A very crude approximation of how these subsidies would rise from the B$70 million in subsidies provided in 2014 (as revealed in the National Health Accounts) can be derived by looking at the increased number of the insured elderly falling within the two subsidy groups (65-74, and 75+) over the next several decades, and then assuming that per capita claim costs continue to remain at their current levels across different age groups.[6,7] The latter assumptions of course assume no increase in real health care costs associated with diagnosis and treatment of those in the elderly age group. The result, as shown below, illustrates the pressures that would be created by the current aged subsidies for the elderly. Excluding continuing care or the geriatric subsidy, would lead to the following trend in the aged subsidy (in million Bermuda dollars):

	2014	**2019**	**2024**	**2029**	**2034**	**2044**	**2054**
Total Aged Subsidy	70.0	85.0	105.9	126.5	139.5	149.0	138.7

With total health care subsidies (including additionally the subsidies for Continuing Care Unit/Geriatric, Indigent and Youth) of roughly $114 million in 2014, one could envisage pressures for total subsidies rising to almost $130 million by 2018, and reaching almost $150 million by 2024 and $190 million by 2034.

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6 To illustrate, if the health insurance scheme covers only 30% of the average claim cost of someone aged 65-74, then the remaining 70% is covered by a government subsidy. Thus, if the health insurance plan's average per capita cost for these elderly is $2000, the government's subsidy is $4666.

7 Although the breakdown by specific age groups has not been projected forward by the Statistics Department, one can use the more detailed age breakdown provided in its projections for 2020 and assume that the breakdown of the shares of different groups among the elderly remain unchanged looking forward, an assumption which will progressively underestimate by a small amount the share of the very elderly within the elderly. The other major qualification is that the CPF's projections of the elderly population over the next 50 years include the total resident population rather than only those insured under the health insurance plan. The Standard Health Benefit insured headcount in FY 2015 was 47,854 in contrast to a total population of roughly 65,000. Without detailed data on the age distribution among the insured elderly, we assume that the insured headcount among the elderly is thus only 74% of the total population in these age groups.

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