PRE-BUDGET REPORT

GOVERNMENT OF BERMUDA
Ministry of Finance

IN ADVANCE OF FISCAL YEAR
2018 – 19

Chapter 1
Purpose of the 2018/19 Pre-budget Report

What Is a Pre-budget Report?

A Pre-budget Report (PBR) is a policy statement issued by the Government prior to the release of the budget. It defines the priorities for the next budget in a medium-term framework covering external developments and internal strategies. The PBR should clearly state the Government's economic and fiscal policy challenges and its objectives and intentions in the medium term.

Like most small states and territories, Bermuda's economy is highly vulnerable to external events, underlining the need for financial and fiscal prudence. This vulnerability is compounded by Bermuda's continuing budget deficits and high level of Government debt, which has doubled from $1.2 billion in 2012 to $2.4 billion in 2017.

The Government has to take a number of actions to address the problems the island faces, and it is important that stakeholders and citizens understand these vulnerabilities, have the opportunity to give their views, and are aware of the factors driving the Government's fiscal policy decisions. The Government should be accountable for developing strategies to cope with both domestic and international turbulence, and the strategies adopted should be transparent and open to criticism and comment. The Government should also be accountable for their execution.

To ensure this, the Government is re-introducing a Pre-budget Report as part of the preparation process for the 2018/19 budget. The last and only Pre-budget Report was prepared in December 2011, under the former Progressive Labour Party administration, as part of the preparation process for the 2012/13 budget. This reflects this Government's decision to participate in the Open Budget Initiative (OBI).

> "Greater transparency and public participation in the budget process [are] more likely to yield spending priorities that serve the best interests of society as a whole… The regular release of information can provoke public debate and encourage accountability. And budget information is important not just for accountability to the public but also for internal management purposes.
>
> Holding the government fiscally accountable requires the production and dissemination of budget information from the formulation stage, through approval, execution, and evaluation (or oversight). Yet around the world today, citizens and

legislatures frequently lack at least some basic information about government decisions and actions at every stage of the budget process."[1]

The Purpose of the Pre-budget Report

The objective of the PBR is to increase public awareness of a government's fiscal and budget policy objectives, and to establish a benchmark for evaluating the conduct of fiscal and budget policy.

The PBR also serves to **educate** the public and encourage debate on the budget strategy and how effectively it copes with current economic and social priorities. The PBR is intended to provide an opportunity for stakeholders such as business and social groups to understand and comment on options for the next budget. This can give stakeholders confidence that the administration's budget policies are grounded in longer-term fiscal and budget strategies.

From the government's perspective, the scope for public misunderstanding of the (eventually chosen) budget strategy is reduced due to a greater public appreciation of the nature of the trade-offs facing the government.

Pre-budget submissions by such groups that respond to the PBR can also **alert** the government to unforeseen pitfalls and alternative policy options and improve the quality of the budget. They may even pre-empt embarrassing policy back-flips after the budget has been handed down, when previously invisible problems come to the fore.

The PBR will also improve the budget preparation process for the **line ministries** in the current budget year as well as forward years, by imparting a clearer knowledge of the government's strategies.

Finally, a PBR increases the **accountability** of present and future governments for effective fiscal policy management. This is at two levels:

- The government can be held accountable for the extent to which the fiscal strategy it proposes in the PBR conforms to the principles of sound fiscal management.

[1] Harika Masud and Jason M. Lakin, "What the Open Budget Survey 2010 Tells Us about the Global State of Transparency", Yale Journal of International Economics, winter 2011, p. 65.

- The government can be held accountable at the end of the fiscal year for the extent to which the realised fiscal outcome conforms to the strategy it proposed for that year in the PBR.

The re-introduction of a Pre-budget Report is a sign of the new Government's commitment to a transparent government in Bermuda, which was one of the key planks included in the new Government's 2017 Election Platform.

The Principles of Good Fiscal Policy

Fiscal policy should be directed to ensuring that prosperity reaches all segments of Bermuda's society while having a sustainable medium-term framework. To date, Bermuda's economy has not worked for all Bermudians, and this Government was elected to ensure prosperity reaches all. To meet these objectives, this Government's fiscal strategy will be framed in accordance with the following principles of sound fiscal management.

- Prudently manage financial risks faced by the Government, including by maintaining general government debt and contingent liabilities at prudent levels.
- Ensure that fiscal policy contributes to the achievement of adequate national saving and, as appropriate, to dampening cyclical fluctuations in economic activity, taking account of the economic risks facing the nation and their impact on the Government's fiscal position.
- Pursue spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the level of the tax burden, while promoting fairness and equity in both spending and taxes.
- Maintain the integrity of the tax system.
- Ensure that policy decisions have regard to their financial effects on future generations.

The last few years have highlighted the conflicting goals policymakers face with regard to fiscal policy: more fiscal stimulus or fiscal austerity. The fiscal tightening pressure has sparked a debate between policymakers. Some governments have embraced austerity in a bid to quickly cut the deficit, while others continue to push for more spending. The way to think about the fiscal split is two-fold.

First, the classical concern: when deficits are high and people are worried about an unsustainable surge in debt, deficit reduction may have a strong positive confidence-building effect that offsets the negative shock to the economy. The counter to that is the Keynesian view: when there is a large output gap and demand remains weak, deficit reduction may weaken demand even more.

The Government takes the position that while risks exist, it is critical that we invest in creating a more diversified economy, which will create stronger economic growth for the island, as our ability to reduce our debt depends on being able to grow our economy and create more jobs in Bermuda. A stronger and more diversified economy will assist in our mission to increase employment across all sections of the Bermuda economy and create jobs and opportunities in not only existing industries, but also new sectors that will drive stronger economic growth in the future.

Risks Facing the Bermuda Economy

In their recent report, the Fiscal Responsibility Panel (FRP) highlighted a number of risks to Bermuda's economy. These risks underscore the need for financial and fiscal prudence, and the Government has considered these risks when framing the 2018/19 budget.

Some of the threats noted by the FRP are as follows:

- *Risks from global initiatives in financial regulation.* The upcoming Caribbean Financial Action Task Force (CFATF) assessment of Bermuda's Anti-Money Laundering (AML) and Counter-Terrorism Financing (CTF) measures remains critically important: a less than positive report would carry a high risk of major damage to Bermuda's financial services businesses.
- *Potential EU action to blacklist Bermuda as a "non-cooperative" tax jurisdiction under the EU Code of Conduct initiative*. It is important to recognize the strong political motivation of those in the EU who object to Bermuda's absence of income tax, and who wish to include Bermuda on any blacklist of "non-cooperative" jurisdictions. Reactions to the Paradise Papers leak illustrate how strong the risk is. While Bermuda has avoided being placed on the EU's initial blacklist and is recognised as a highly transparent jurisdiction, along with other jurisdictions it has also been given a deadline to address concerns that have been raised by some EU countries.
- *US tax reform.* The recent US tax changes contain measures that would tax payments of insurance premiums made from the USA to offshore companies, which would adversely affect Bermuda's insurance businesses. There is also the

more general impact on Bermuda's comparative advantage as a place to do business of the significant reduction of US corporate tax rates from 35% to 21%.

- *The general rise in populism and economic nationalism in advanced economies*. The risk remains that this might lead to measures that would adversely affect Bermuda, which benefits hugely from globalisation in general and international capital mobility in particular.
- *Impact of global warming and climate change.* With global warming, extreme weather events are becoming more frequent. Bermuda escaped the impact of the hurricanes this year that did so much damage in the southern USA and in the Caribbean.
- *Effects of an aging population, declining workforce, underfunded public sector pension funds and escalating health-care costs.* This remains a certainty, not just a risk, which will result in serious longer-term pressures on public spending, challenges to growth, and make it more difficult to deal with a large debt overhang. Concern about this is a further factor that could ultimately trigger a downgrade by rating agencies, as has happened elsewhere.

Chapter 2
Economic and Fiscal Performance

Global Upswing in Economic Activity is Strengthening – Bermuda Remains Challenged

According to the latest World Economic Outlook released by the IMF in October, the global upswing in economic activity is strengthening. Global growth, which in 2016 was the weakest since the global financial crisis at 3.2%, is projected to rise to 3.6% in 2017 and to 3.7% in 2018. The growth forecasts for both 2017 and 2018 are 0.1% stronger compared with the April 2017 World Economic Outlook (WEO) forecast. Broad-based upward revisions in the euro area, Japan, emerging Asia, emerging Europe, and Russia – where growth outcomes in the first half of 2017 were better than expected – more than offset downward revisions for the United States and the United Kingdom. But the recovery is not complete: while the baseline outlook is strengthening, growth remains weak in many countries, and inflation is below target in most advanced economies.

The US economy has continued to expand. Since the USA is Bermuda's largest trading partner, and the source of the overwhelming majority of tourists, its economy's performance to date is good news.

However, despite the growth in the US economy, Bermuda continues to experience economic challenges. In 2016, the Bermuda economy contracted by 0.1% based on constant market prices (real GDP). This fell slightly short of the Ministry of Finance's expectations of an increase in GDP of 0.0–1.0%. The largest value declines in real terms were recorded for the financial intermediation and international business industries. In contrast, the construction industry recorded the largest gain in value.

2016 was the 7th year of economic contraction in the last 8 years, which shows the urgency that must be placed on jumpstarting its economy and investing in long-term policies that will diversify the Bermuda economy and create sustained economic growth that reaches all levels of Bermudian society.

The Bermuda Economy in 2017 and the Future Outlook

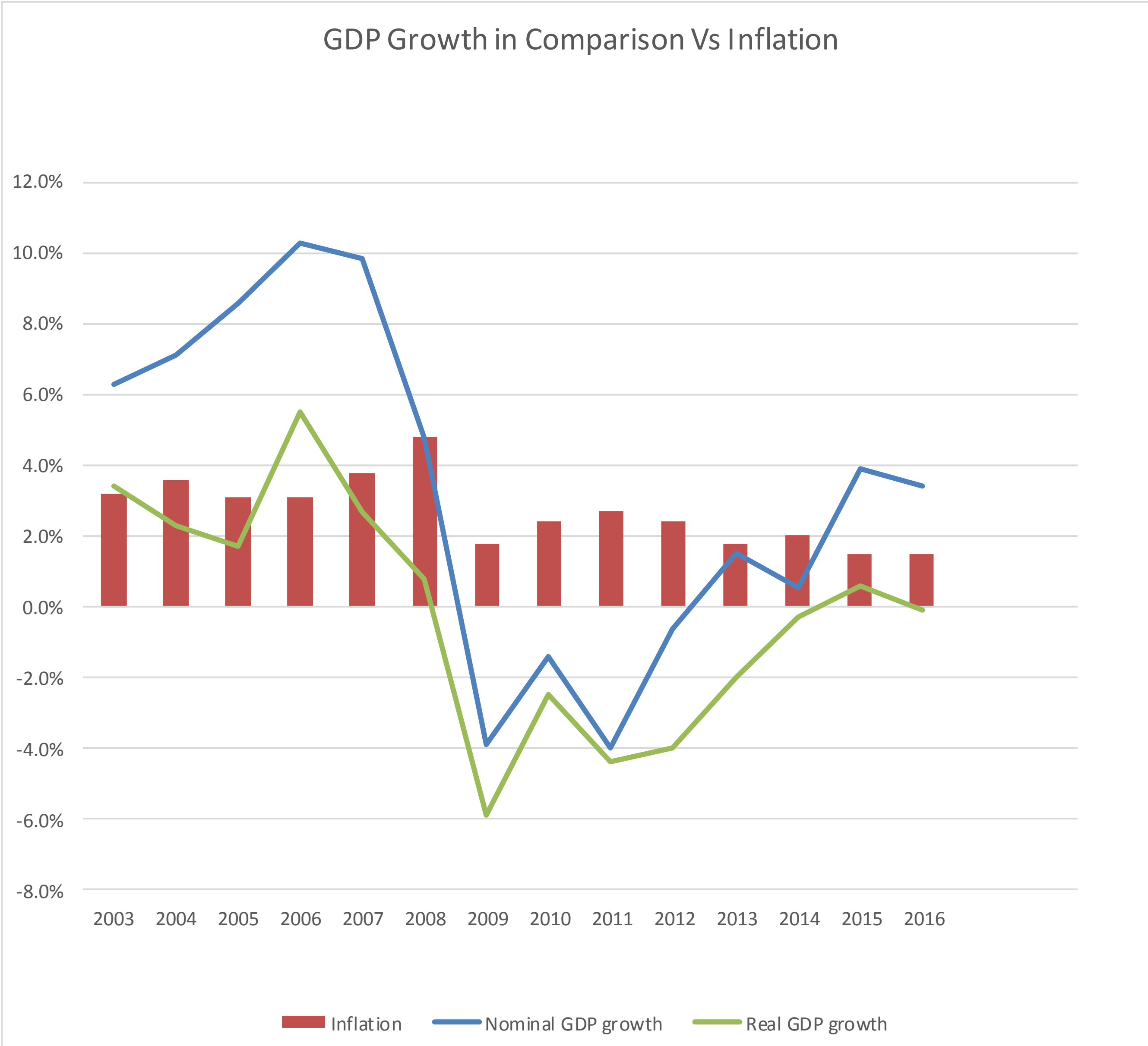
Summary Economic Indicators: Mid-Year Economic Review 2017

***Comparative data over the first half of 2017, except when otherwise indicated.**

- The year-to-date (September) average Consumer Price Index was 2.0% and the 12-month average rate was 1.9%. The primary causes of inflation during the last 12 months were increased costs of airfares, due to the privatisation contract at the LF Wade International Airport and fuel prices in the Transport & Foreign Travel sector, the higher costs of electricity, and increases in the average cost of tuition fees for local schools and overseas colleges.
- Imports increased by 25.7% in the first two quarters of the year to register at $604 million. The growth was primarily attributed to the imports of finished equipment, which grew by $61.0 million or 39.3% when compared with the first six months of 2016. These imports were related to the America's Cup sailing event, which took place in the second quarter of 2017. Other categories that contributed significantly to the positive results were transport equipment and machinery.
- Air arrivals to September 2017 grew by 10.0%, while the number of cruise passengers increased by 8.4% over the same time period. Total visitor arrivals were up 9.0% versus a year ago.
- Total visitor spending in the first three quarters rose by $55.3 million or 21.9%, settling at $307 million.
- Some 362 new international companies and partnerships were registered in Bermuda during the first six months of 2017, representing a 9.3% decrease compared with 2016 registrations of 399.
- The total value of new construction projects started for the first six months of this year increased by over six times the amount of $67.8 million recorded in the same time period in 2016. In the second quarter, the Airport Redevelopment and St. Regis projects began, which are worth over $500 million in total.
- The estimated value of construction work put in place was $51.0 million, a decline of 18.4%. The majority of the decrease can be attributed to a reduction in the levels of work performed on residential properties, offices, shops and warehouse building projects.

- Employment income grew by $54.2 million to $1.78 billion, an increase of 3.1%.
- Total retail sales for the first nine months of 2017 increased by 3.2% or $28.8 million to register at $915.3 million.
- Bermuda's Balance of Payments over the first two quarters of 2017 recorded a surplus on the current account of $462 million, which was $149 million more than the corresponding surplus in 2016. The increase in the current account surplus was mainly due to changes in the primary income account, where there was significant growth in net investment income received from non-residents in the amount of $241 million year over year.
- Based on figures released by the Bermuda Monetary Authority, Bermuda's money supply expanded by 2.4%, or $171 million, year over year at the end of the second quarter of 2017. The money supply grew mainly due to higher inflows of customer deposits and an increase in notes and coins in circulation.
- The Banking sector's total assets declined by 7.8% or $3.7 billion at the end of June 2017. The reduction was driven by a year-over-year decrease in investments and loans in the first quarter and a decrease of interbank deposits in the second quarter.
- Loans & Advances fell by 7.8% or $1.4 billion over the first two quarters of 2017, while customer deposits also contracted by 20.3% or $1.8 billion for the same time period.

This year's economic data, thus far, is consistent with the expectation in the 2016 National Economic Report of Bermuda and the Ministry of Finance's own macroeconomic forecasts. Given that most economic sectors experienced a one-time boost from the hosting of the America's Cup, GDP in 2017 is projected to expand. However, for growth to continue, investment is needed to ensure that economic momentum is not lost. The new Government's desire to create new economic pillars and enact policies to grow Bermuda's economy will provide sustained economic growth through the medium term.


GDP Growth in Comparison Vs Inflation
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
Inflation
Nominal GDP growth
Real GDP growth

Credit Ratings

The Government currently holds long-term foreign currency credit ratings of “A+” (stable outlook) from Standard and Poor’s (S&P) and “A2” (stable outlook) from Moody’s Investor Services (Moody’s). In 2017, the Government continued to maintain its investment grade credit ratings at a time when various other countries have been downgraded.

Public Debt Concern

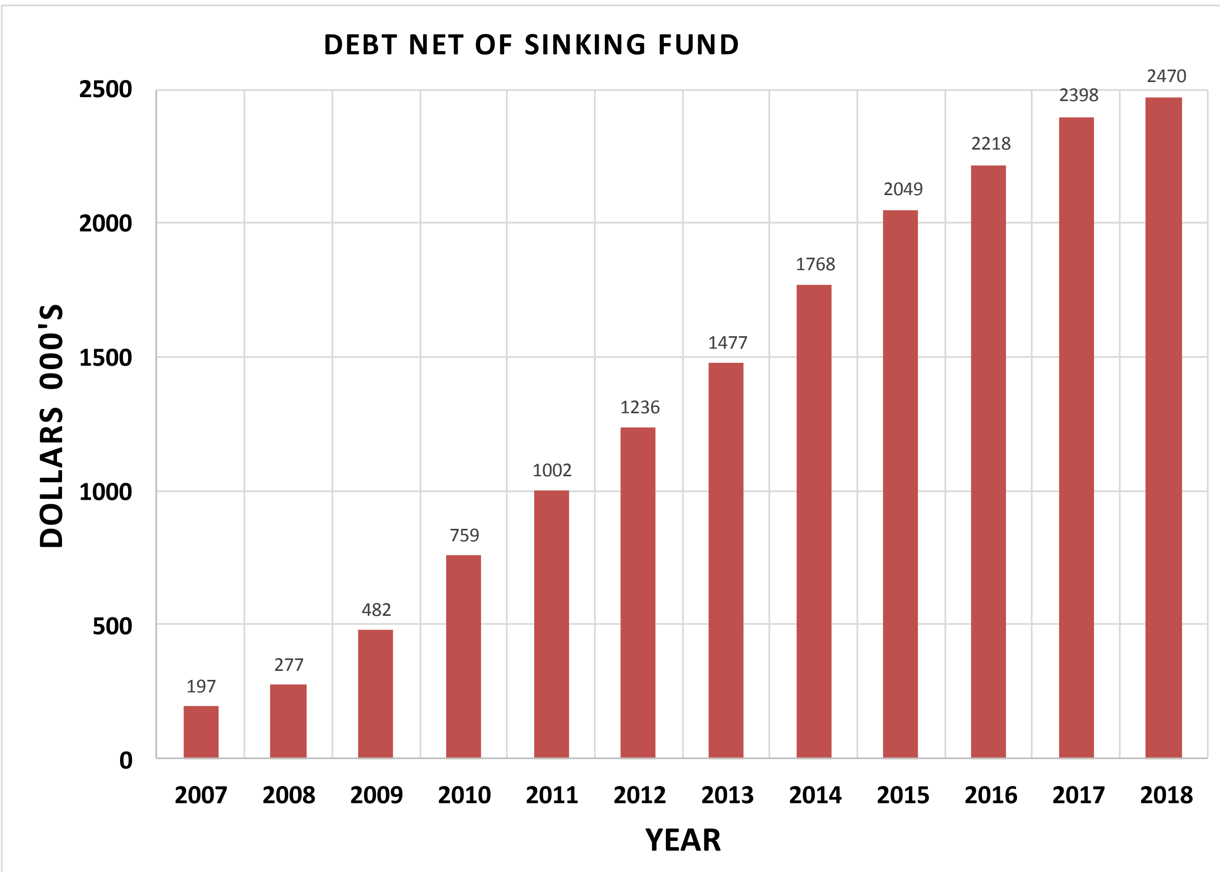
Current global and local economic conditions are improving, but there is still pressure on public finances. Since 2008, the level of national debt has increased sharply and the Government regards persistent growth in debt as a serious challenge. Over the last six years, Bermuda has added $1.27 billion to the national debt. At the end of this fiscal year, total net Government debt outstanding will rise to approximately $2.47 billion, which is only $30 million below the current statutory debt ceiling of $2.5 billion. Therefore, the debt ceiling will have to be raised for the 2018/19 budget.

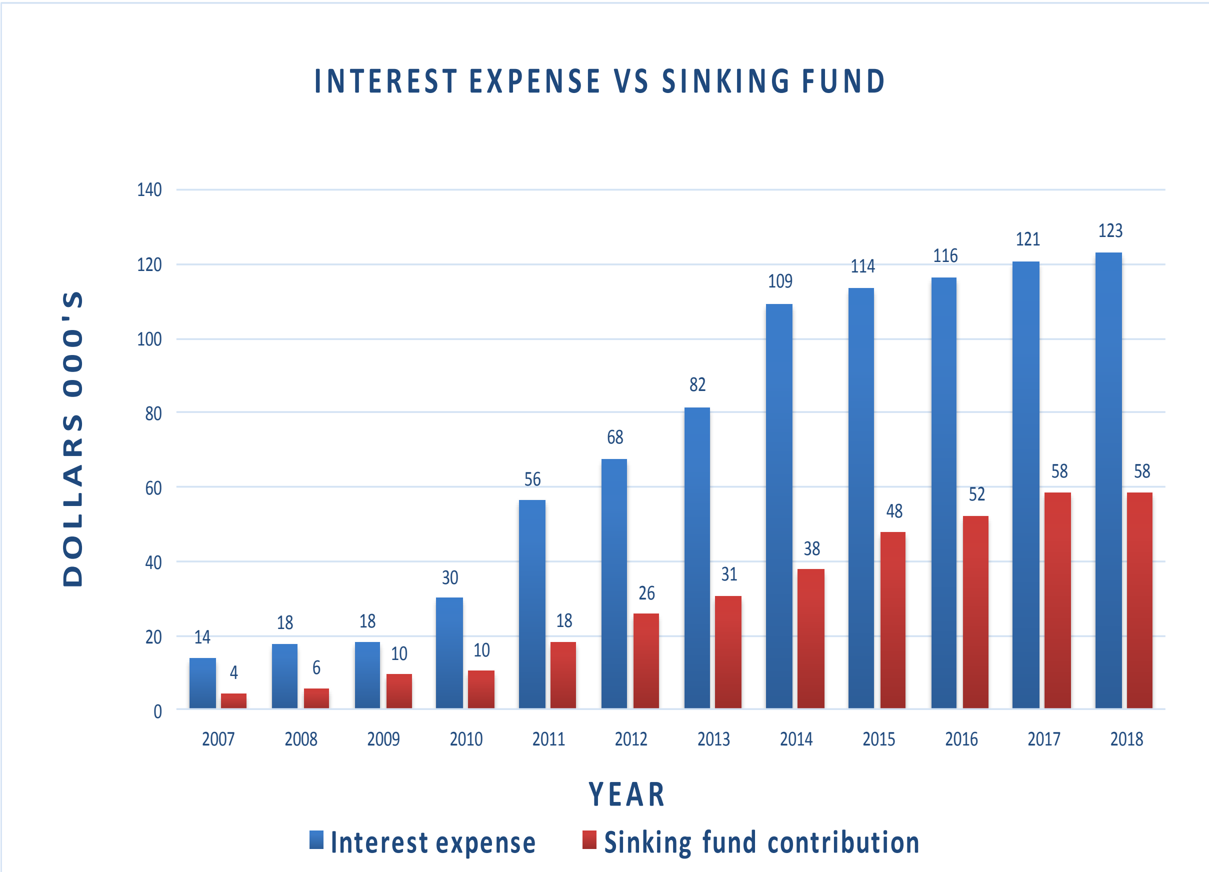
Like most small states and territories, Bermuda’s economy is highly vulnerable to external events; the following vulnerabilities are common to many small states and territories including Bermuda:

- A high degree of openness means they are heavily exposed to external shocks in global markets.
- Their narrow resource base and small domestic markets prevent small economies from diversifying into a wide range of activities, making them more vulnerable to terms of trade shocks. When one dominant activity declines, it has an impact throughout the economy, which is the case in Bermuda, where the insurance sector is dominant.
- Government revenues are also volatile.
- Most are vulnerable to natural disasters.
- Capital markets tend to see small states as more risky than larger countries.

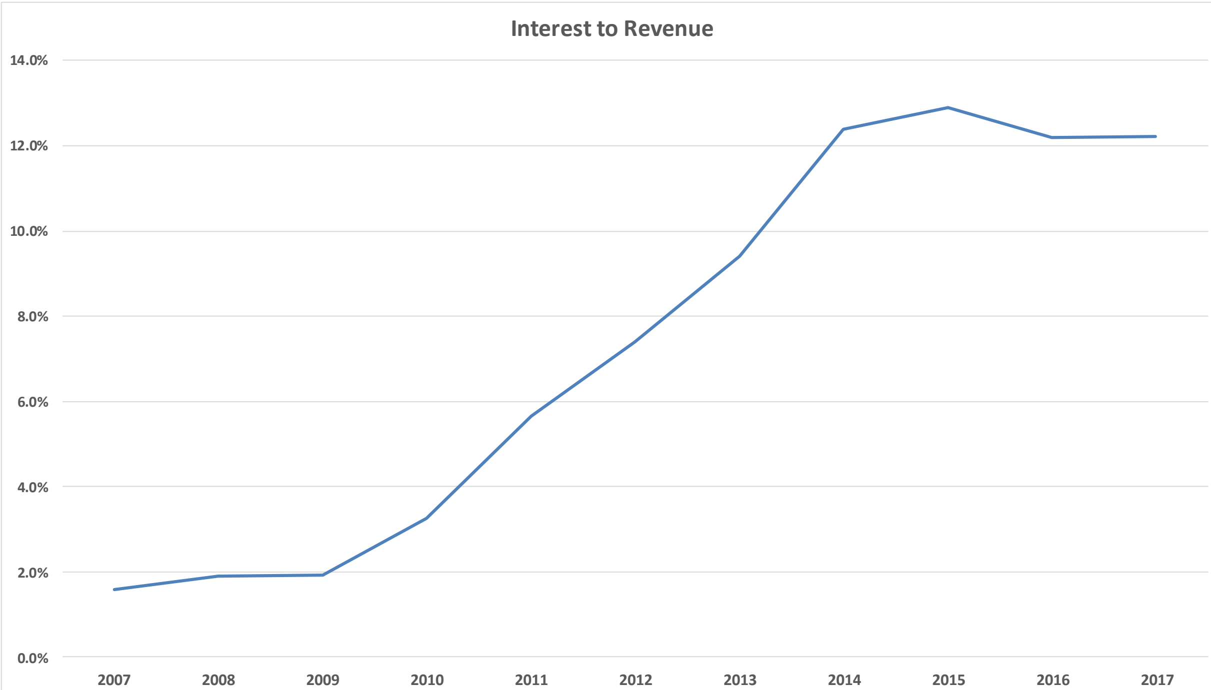
The above vulnerabilities underline the need for lower debt levels than larger jurisdictions, but they also point to the urgent need to diversify Bermuda’s economy. The annual debt service cost is currently $124 million, claiming 11.9 cents of every dollar the government takes in. Some similar jurisdictions facing similar circumstances have been forced by external events to take action to reduce deficits and set out formal rules for limiting deficits and debt.

The Government remains committed to the targets of halting the rise in our debt by 2019/20 and thereafter working to reduce net debt, so as to achieve target ratios for debt and debt service to Government revenues of less than 80% and 10% respectively. However, it is important to note that it will not be possible to meet those targets without a growing and diversified economy that creates balanced economic growth and that benefits all Bermuda residents.





INTEREST EXPENSE VS SINKING FUND
DOLLARS 000'S
140
120
100
80
60
40
20
0
14
4
18
6
18
10
30
10
56
18
68
26
82
31
109
38
114
48
116
52
121
58
123
58
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
YEAR
Interest expense
Sinking fund contribution


Interest to Revenue
14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017

2016/17 Actual Fiscal Review

The total revenue raised by the Consolidated Fund for the fiscal year 2016/17, excluding extraordinary revenue of $41.6 million from the reconveyance of Heritage Wharf from WEDCO, was approximately $988 million, representing an increase of $27.2 million (2.8%) from the fiscal year 2015/16's total revenue of $960.7 million. This was below original budget estimates by approximately $8.9 million (0.9%). The most significant generators of revenues for the fiscal year 2016/17 were payroll taxes, accounting for $401.8 million or 39.0% of total revenue (2015/16 – $361.1 million or 37.6%) and customs duty, accounting for $211.1 million or 20% (2015/16 – $192.6 million or 20%).

Current expenses for the fiscal year 2016/17 were $1.277 billion (2015/16 – $1.176 billion). The three largest components of current expenses were employee costs, grants and contributions and interest on debt. Total employee costs were $525.7 million or 42.9% (2015/16 – $532.4 million or 46.2%) of total expenses. Included in this amount is $75.9 million (2015/16 – $79.1 million) of non-cash retirement benefit expenses. Grants and contributions were $293.2 million or 23.9% (2015/16 – $298.2 million or 25.9%) and interest on debt was $120.6 million or 9.8% (2015/16 – $116.2 million or 10.1%). Total current expenditure on a modified cash basis was $1.093 billion (2015/16 – $1.071 billion), which was $15.7 million less (2015/16 – $30.6 million less) than the original budget estimates.

Total capital account cash expenditure was $76.7 million, which was $10.6 million lower than the original budget estimates.

Total capital and current account cash expenditure for 2016/17 was $1.170 billion, which was $26.3 million or 2.2% lower than the original budget estimate of $1.196 billion.

Cash and cash equivalents at the end of the fiscal year 2016/17 totalled $95.7 million, which was $53.6 million higher than the balance at the end of 2015/16.

The 31st March 2017 total accounts receivable net of provision for doubtful accounts decreased by 4.2% to $156.5 million, as compared with $163.5 million at 31st March 2016. The most significant contributor to the accounts receivable balance before provision was the Office of the Tax Commissioner (OTC) of $227.8 million, representing an approximate $8.3 million increase in accounts receivable from 31st March 2016 ($219.5 million). The increase in the gross accounts receivable for the OTC was offset by an increase in the respective allowance for doubtful accounts balance of $9.2 million to $90.6 million in the fiscal year 2016/17 from $81.4 million in the fiscal year 2015/16. The net accounts receivable balance was 15.2% of revenue for the year (2016 – 17.0%). A significant portion of the gross accounts receivable at 31st March 2017 (57.0%) represents payroll tax that was due and payable on 15th April 2017. During the month of April 2017, the Government collected approximately $112.0 million in payroll taxes (April 2016 – $101.6 million). The 2017 allowance for bad debts was $126.0 million, representing a $9.7 million or 8.3% increase from 31st March 2016.

The closing Net Book Value of Tangible Capital Assets for the year was relatively consistent at $686.0 million (2016 – $660.9 million), an increase of $25.1 million or 3.8% on the year.

Net Public Debt, which excludes guarantees and is net of the Government Borrowing Sinking Fund, increased by $179.6 million (2015/16 – $168.1 million) during the fiscal year 2016/17, standing at $2.397 billion (2016 – $2.218 billion) at the end of the year. This represents an 8.1% increase from 2016. Items of note:

- There was a public debt issue of $665 million in October 2016. A portion of the proceeds was utilised to retire $276.1 million of higher interest-bearing senior notes and to retire a $200 million BNTB loan facility.
- $90 million of senior notes were retired during the year, drawing on funds from the Sinking Fund.
- The 2017 Sinking Fund balance was $86.6 million (2016 – $117.3 million). At the close of the year, the available borrowing limit was $102.7 million (2016 – $282.3 million).

A full actuarial valuation was carried out at 31st March 2017. The actuarial valuation resulted in a liability for pensions and retirement benefits of $1.402 billion (2015/16 – $1.328 billion), representing a 5.5% increase from 31st March 2016, which is net of Plan Assets of $608.2 million (2016 – $603.2 million).

2018/19 Mid-Year Fiscal Performance

The headline numbers for the 2017/18 National Budget were: a revenue target of $1.04 billion; current expenditure of $1.11 billion, including debt service; capital expenditure of $67.5 million; and a projected deficit of $134.7 million.

Total revenues for the six months ending September 2017 are $31.2 million (6.3%) above September 2016. This is due to higher collection in customs duty, payroll tax and stamp duty, offset by lower collections in Passenger Tax and Civil Aviation receipts due to the privatisation of the airport and the transfer of the Department of Civil Aviation out of the Government.

In general, total revenues are tracking higher than budget estimates and the strength in payroll tax and customs duty receipts increases the chances of meeting or exceeding the total revenue target of $1.042 billion for the current fiscal year.

Customs Duties are tracking 10% above budget estimates and $10.9 million above 2016 receipts, while payroll taxes are tracking 5.8% above budget estimates and $27.2 million higher than 2016 receipts.

Current expenditures, excluding debt service, for the period ending September 2017 are $6.4 million lower than in September 2016; Government current account spending to date is lower during this fiscal year when compared with the same period last year, mainly due to lower professional services offset partially by increases in grants and contributions in relation to the Bermuda Airport Authority and the America's Cup.

Overall, current expenditures, excluding debt service, are presently tracking 0.8% or $3.6 million above budget estimates. The $465.4 million spent in the first six months of 2017/18 represents approximately 50.4% of the total current account budget of $923.5 million.

Capital expenditures for the period ending September 2017 are $1.1 million lower than in September 2016. This is due to decreases in the capital grant for the America's Cup, which was completed in June 2017.

Interest expenses are equivalent to 2016.

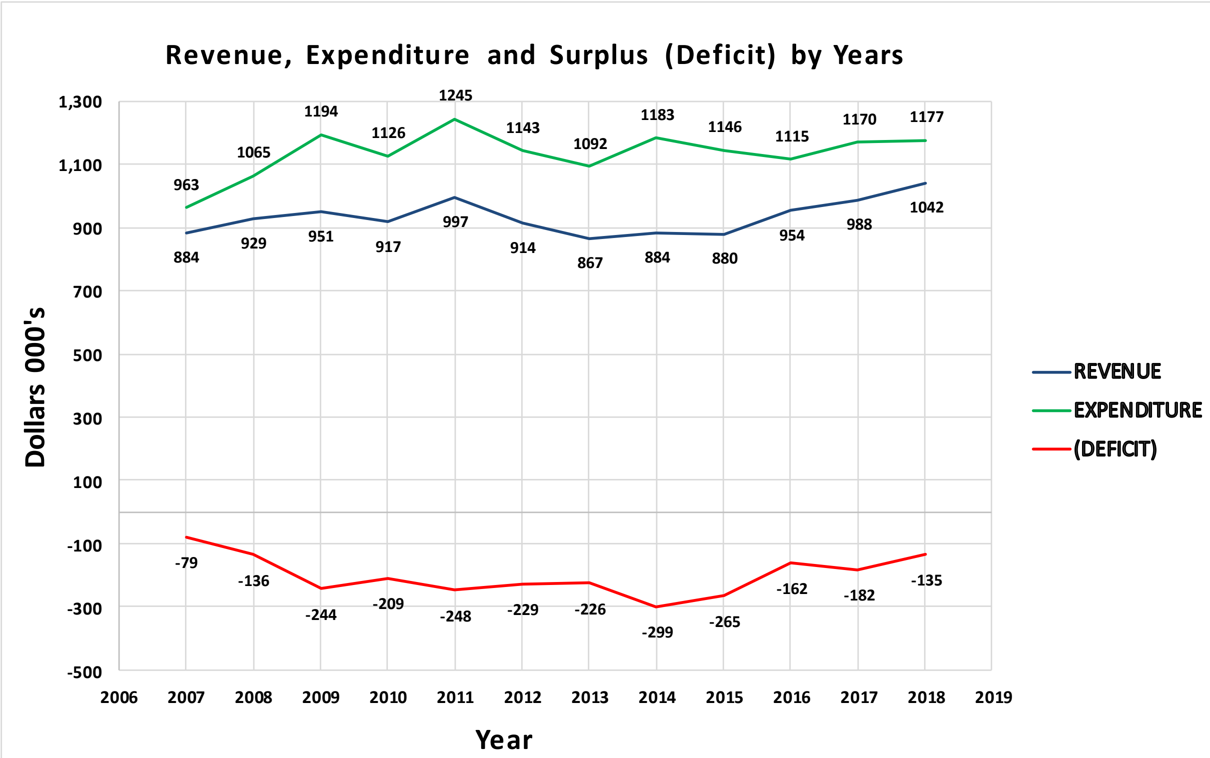
Excluding debt service, the Government recorded a $57.6 million current account surplus for the first six months of the year.

For the first six months of 2017/18, the Government incurred a total deficit of $63.4 million compared with a deficit of $100.2 million in 2016. This deficit was financed by a credit facility and working capital.

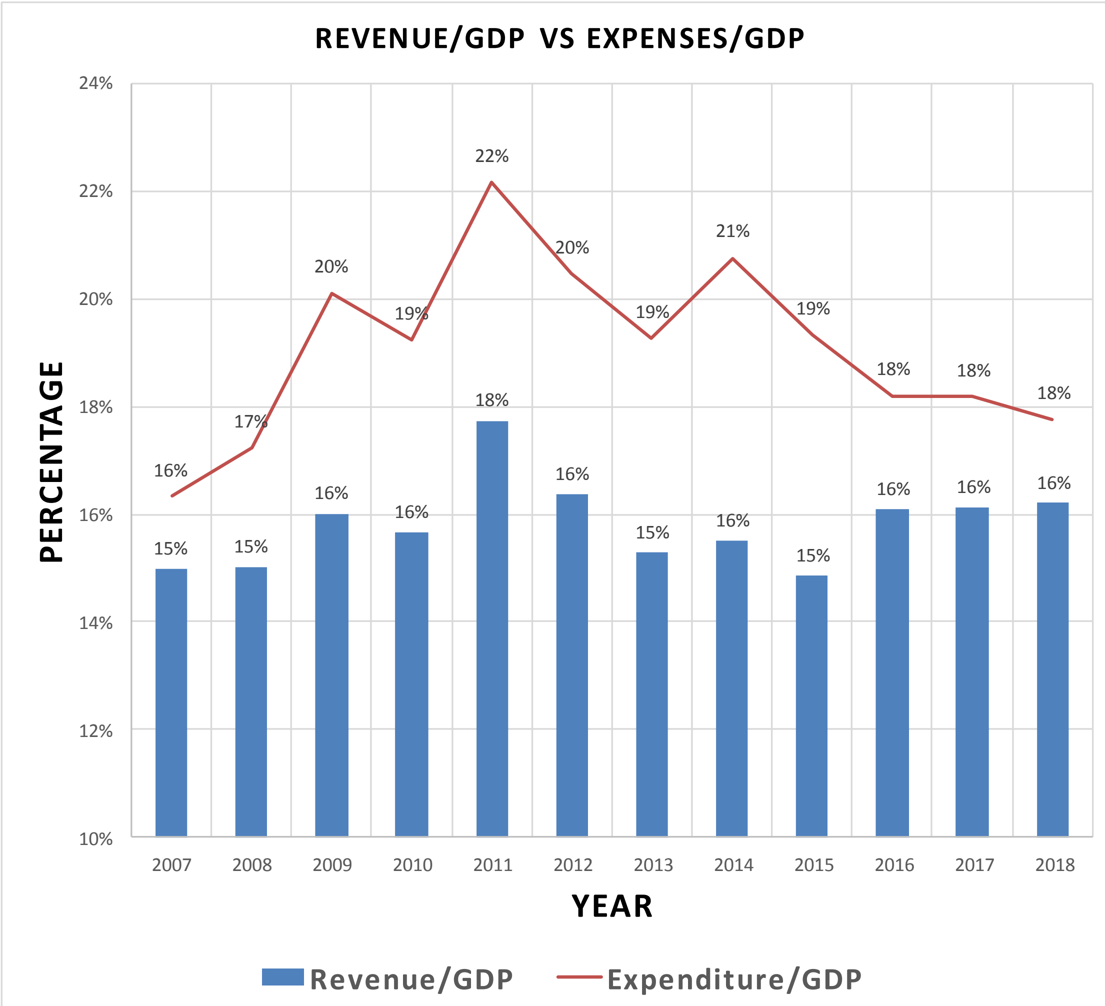
Gross debt at the end of September 2017 stood at $2.515 billion. Net of the Sinking Fund, debt was $2.428 billion.

The Government's revised current account expenditure, excluding debt service, is expected to be $914–$932 million, which is in line with the original estimate of $923.5 million provided in the budget.

The Government has financed the estimated deficit for the fiscal year 2017/18 for 18 months, through a 4.0% US$135,000,000 loan facility agreement with Butterfield Bank Limited.



Revenue, Expenditure and Surplus (Deficit) by Years
Dollars 000's
1,300
1,100
900
700
500
300
100
-100
-300
-500
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
Year
963
1065
1194
1126
1245
1143
1092
1183
1146
1115
1170
1177
884
929
951
917
997
914
867
884
880
954
988
1042
-79
-136
-244
-209
-248
-229
-226
-299
-265
-162
-182
-135
REVENUE
EXPENDITURE
(DEFICIT)


REVENUE/GDP VS EXPENSES/GDP
PERCENTAGE
24%
22%
20%
18%
16%
14%
12%
10%
22%
20%
21%
20%
19%
19%
19%
18%
18%
18%
17%
18%
16%
16%
16%
16%
16%
16%
16%
16%
15%
15%
15%
15%
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
YEAR
Revenue/GDP
Expenditure/GDP

Chapter 3

The Government's Fiscal Strategy for 2018/19

"In order for Bermuda to succeed, we need to return our economy to a path of balanced growth that creates jobs, provides rising income and assists our budget challenges. It is our belief that a better environment must be created in which Bermudian businesses can thrive, opportunities for Bermudians can be created, and in which capable, qualified Bermudians can earn opportunities to work, train and succeed at every level."

– Progressive Labour Party 2017 Election Platform

New Government Policies

Our promise to the people of Bermuda was and is to harness the power of Bermuda's economy to produce a fairer, more just society in which economic growth is the engine of success for more of our citizens. We will have started that work through the following measures:

- A **Tax Reform Commission** (TRC) has been announced with a broad membership, to review Bermuda's system of revenue collection and taxation and make recommendations for reform designed to make the system fairer, enhance competitiveness and increase jobs. Initially the Commission, which is likely to start its work in January, has a six-month deadline to produce its recommendations. This is important, as there is an urgent need to create a more just tax system.
- The **Bermuda First** Advisory Group has been established to develop a long-term economic and social vision for the island. There are proposals designed to stimulate growth through government policies, including the creation of an Economic Diversification Unit.
- The Government intends to take forward the work of the **Bi-partisan Committee on Immigration Reform** to ensure that the rights of Bermudians are advanced and protected, while recognising the need to grow the economy with balanced work permit and residential policies. This bi-partisan committee is building on the principles outlined in the October 2017 report from the Immigration Working Group. Legislative amendments to immigration policy will be placed before parliament in the summer of 2018.

- On public expenditure, **Parliamentary Oversight Committees** are being established to improve governance, reduce waste and increase efficiency. There are also proposals to improve government efficiency through better use of technology.
- A new **Bermuda Infrastructure Fund** has been established that is intended to channel private sector investment into Bermuda's infrastructure assets. The Government has agreed to underwrite the management fee. Possible projects range from energy and sewage to commercial and residential property.
- A joint Parliamentary Select Committee has been established to make recommendations on establishing a legal **"living wage"** for Bermuda. This will fulfil our new Government's pledge to ensure that workers can live in dignity and are not working simply to remain in poverty.

Framing the 2018/19 Budget

The key factors which have impacted upon the framing and composition of the 2018/19 budget include economic considerations, taxation sensitivities, continuing deficits and high debt levels, and the implementation of the Government's fiscal strategy to halt the rise of our debt by 2019/20.

Taxation sensitivities relate to the perception by tax payers of the weight of the existing tax burden and their willingness to absorb further tax rate increases. The 2017/18 budget presented by the former administration featured a $45 million (7.7%), increase in revenues. The Government is in the process of establishing a Tax Reform Commission to review our tax system; however, the need for additional revenue is immediate. Therefore, in 2018/19, it is proposed to increase revenue by $50 million. The proposed revenue measures are discussed later in this report.

Controlling Public Sector expenditure remains a focus of the Government. Whilst there has been some success in cutting costs, it has become increasingly difficult to implement further reductions under the current Government structure and the across-the-board expenditure cuts in previous budgets.

The Government's 2017 Election Platform called for increased Government efficiency in order to control Government expenditure, rather than across-the-board cuts. To this end, the Government will establish an Efficiency Team to scrutinise the spending of resources across departments according to the Government's priorities. Specifically, the Efficiency Team will scrutinize public expenditure to identify specific savings and implement action plans for each department to increase efficiencies that will lead to cost containment. Chapter 4 of this report contains more information on the Efficiency Team.

The work of the Efficiency Team will not be implemented in advance of the 2018/19 budget cycle. Therefore, to meet the objectives of providing targeted investments to grow and diversify Bermuda's economy, the Government proposes to set the total current account appropriation, less debt service, at approximately $937 million. The amount is equal to the revised budgeted expenditure that has been approved for the current 2017/18 fiscal year **(total current expenditure will remain unchanged)**. The Government remains committed to balancing the budget. However, if unrealistic targets are established and not met, this undermines the credibility of the Government pertaining to public commitments on cost control.

It is also critical that we maintain and strengthen our infrastructure and stimulate economic activity, therefore the Government plans to set capital expenditure at a prudent level of $50–$55 million.

The Government's intention is to target a deficit in 2018/19 that is about $25 million more than the contribution to the Sinking Fund (estimated at $65.5 million). Thereby, it is expected the net debt will increase by $25 million. This deficit target is about $45 million below the expected deficit for 2017/18. The Government intends that net debt will begin to decrease in 2019/20 and that Bermuda will then begin to reduce the national debt.

Policy Options under consideration for 2018/2019 Budget

The following are **considerations** for inclusion in next year's budget. One of the main objectives of a pre-budget statement is to provide a document that elicits discussion from stakeholders. Prior to finalising the budget, the Government will hold public forums and meetings with stakeholders and discuss the ideas outlined below.

Payroll Tax

In 2017/18, the former Government reformed payroll tax, making it progressive, as well as providing additional revenue. Customs duty was also increased, and a new Financial Services Tax on Banks, Insurance Companies and Money Service Businesses was introduced. The former Government's overall proposals for the 2018/19 budget were as follows:

- Continuing the payroll tax reform to increase progressivity and provide additional revenue;
- Increasing customs duty and excise taxes;
- Introducing a GST; and
- Various other smaller increases in fees and taxes.

It was anticipated that these proposals would generate revenue in 2018/19 of $1.110 billion.

The Payroll Reform was as follows:

Taxation on Employer	Year 1	Year 2
Class of tax payer	Rate	Rate
Annual payroll > $1,000,000	10.25%	11.25%
$200,000 ≤ Annual payroll ≤ $500,000	7.00%	8.00%
Annual payroll < $200,000	1.75%	1.75%
$500,000 < Annual payroll ≤ $1,000,000	9.00%	10.00%
Exempt undertakings	10.25%	11.25%
Government, Government Boards, Parish Council, & Bermuda College	0.00%	0.00%

Taxation on Employer	Year 1	Year 2
Taxi, Farm, Fish & Education, Sport, Scientific Institution	1.75%	1.75%
Charities, Schools, Religious and Cultural Organisations	0.00%	0.00%
Economic Empowerment Zone	0.00%	0.00%
BHB, Corporation of Hamilton and St Georges	3.50%	4.50%
Hotels & Restaurants w/annual payroll ≥ $200,000	6.00%	7.00%

Taxation on Employee	Year 1	Year 2
Income band	Rate	Rate
0 – 48,000	4.75%	4.25%
48,000 – 96,000	5.75%	5.50%
96,000 – 235,000	7.75%	9.00%
235,000 ≤	8.75%	11.00%

In their latest report, the FRP noted the following:

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

Taking into consideration the above, and the recent US tax reforms, the Government is considering not moving ahead with the implementation of the second phase of the payroll tax proposal put forward by the former Government. This Government is very cognisant of the contribution made by International Business (IB), which is 27% of GDP. With the short time afforded to international business to work out the impact of the US tax reform, we believe that it is wise for this Government to reduce uncertainty and send a clear message concerning the importance of IB to Bermuda's economy. The Government still intends to lower the rates of payroll tax for lower income workers and will ensure that any measures to offset that reduction from higher earners will not increase the overall payroll tax burden in the economy.

Incentives to Repatriate Jobs to Bermuda

We will work very closely with key business stakeholders over the next couple of months to create incentives to relocate jobs to Bermuda and will consider providing payroll tax relief for the repatriation of jobs back to Bermuda.

Payroll Taxes for the Taxi Industry

The Government is currently considering a proposal from the Bermuda Taxi Owners Association for an amendment to the Payroll Tax Rates Act 1995. This proposal involves a one-time payroll tax payment per taxi to be paid yearly at the Transport Control Department, in addition to the licensing fee, at or before the end of September.

Cracking Down on Notional Abuse

The Office of the Tax Commissioner (OTC) has undertaken a process to review and amend notional income levels for the professions deemed particularly at risk of under-declaration and has notified the professionals of the revised notionals. As a second step, in the near future, the OTC intends to update the Payroll Tax Act with more objective criteria for determining notionals going forward and will seek to enforce the notionals more robustly in the future. The Government will increase resources at the OTC to perform audits of those declaring notional salaries to cut back on abuse and to ensure that all pay their fair share.

Financial Service Tax

In the 2017/18 budget, the former Government enacted the Financial Services Tax Act 2017. This act introduced a financial services tax on insurance premiums, excluding health, money transmissions of a money service business and bank assets. Since the Act came into force, there have been some queries from the financial service providers in the insurance sector with regard to the definition of “gross premiums”, therefore, in 2018/19, the Government will amend the Financial Services Tax Act 2017 to provide for greater certainty.

General Service Tax

The General Service Tax (GST) will not be implemented in 2018 as proposed by the previous government, but as an interim measure, the Government is considering implementing a **Professional Services Tax (PST)** in 2018/19, limited initially to services provided in the legal and accounting professions and other business and management consultancy services. This PST is to be imposed on selected services delivered to companies resident in Bermuda. The tax is to be charged/payable by every registered service provider on the value of services to final consumers or other businesses.

Customs Duty

The following are the changes to customs duty currently under consideration by the Government:

- The Speech from the Throne on 8th September 2017 formally introduced the policy for a **sugar tax**. The Speech stated: *"…the Government will begin consultation for the introduction of a Sugar Tax on the sale of certain foods and beverages in Bermuda."* It is proposed to introduce the sugar tax as an increase in the rate of duty on a limited group of items. The Ministry of Health has already released a consultation paper on this matter.
- To reduce the cost of certain essential foods and textiles, the Ministry of Finance is considering duty relief on these items.
- The Ministry of Finance, in consultation with the Ministry of Health, is planning on further increasing the duty on tobacco imports to close the inconsistency between duty rates on cigarettes and tobacco.

Biennial Fee Increase

The biennial fee increase is scheduled to take effect this year. All fees will be reviewed to ensure that there is reasonable cost recovery for the provision of the various services offered by a range of government departments.

Telecommunications Sector

As an additional revenue measure, the Government is considering increasing fees on cell phones and the Government Authorization fee of 2.5% imposed on the electronic communications industry.

Commercial Rents

Some Bermudians have enjoyed the benefits of international business's continued presence in Bermuda and collect commercial rents from their properties in the City of Hamilton and elsewhere. In order to broaden the tax base, the Government is considering taxing commercial rents. The tax will be charged on persons who rent out commercial properties for rental income. Initially, it is proposed that the tax will be charged on the annual rental value of the property and that certain deductions, such as mortgage payments, will be allowed. There may also be exemptions for certain areas such as the Economic Empowering Zones.

Tax Collection & Accounts Receivable

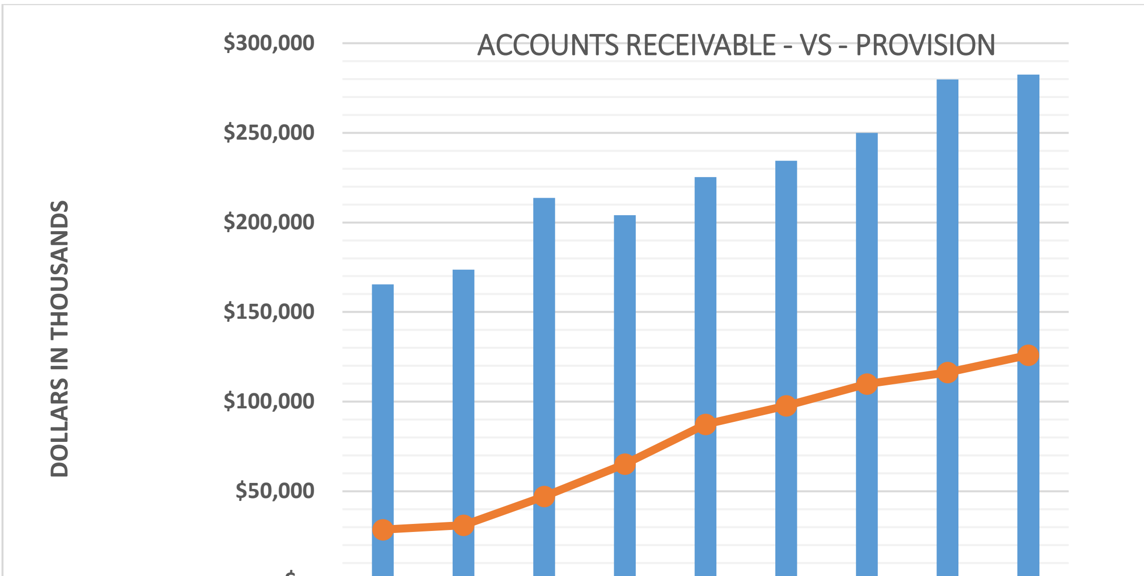
Tax collection and accounts receivable have been a considerable problem for the Government for years and it is time to take additional action.

The Government will ensure that the Office of the Tax Commissioner (OTC) has the resources that it needs to collect taxes that are due. Due to staffing shortages, not all taxes are being collected and adjudicated. The Government has authorised the filling of these long-vacant posts to assist in revenue collection.

The Government will also enhance the links between IT systems in government departments to place more restrictions on individuals, homeowners and business who are not current with their tax obligations. These links will also assist the OTC in identifying employers who may be underreporting taxes to better direct resources for enforcement.

The Government will take additional action by looking at all accounts that are listed as "provision for bad debt". These accounts will be analysed and those accounts that are deemed collectible and do not have payment plans in place will be handed over to the Debt Enforcement Unit in the Attorney General's Chambers to take action.

The Government is considering implementing a Tax Amnesty Programme. The proposed amnesty would provide eligible tax payers with a defined timeline to settle the total amount due in return for forgiveness of the late penalties that have been assessed as part of long-outstanding tax bills.



	2009	2010	2011	2012	2013	2014	2015	2016	2017
ACCOUNTS RECEIVABLE	165,443	173,651	213,687	204,100	225,368	234,339	250,021	279,771	282,502
PROVISION FOR BAD DEBT	28,616	31,064	47,051	65,129	87,393	97,714	109,924	116,319	125,986

The Government emphasises that the policy options listed above are for discussion purposes and that no decisions on any of the above for the 2018/19 budget have been made. During the month of January, the Government will hold public meetings on the above policy options to encourage public debate and discussion on the priorities for the 2018/19 budget. The Government welcomes feedback on this report, as we look to involve as many as possible in the Open Budgeting Process.

Historical Economic and Fiscal Information

As of or for fiscal year ended March 31 (except as specified)

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
	(dollars in millions, except ratios and GDP per capita)									
Bermuda's economic data										
Nominal GDP	6,178.7	5,938.9	5,855.3	5,620.4	5,585.4	5,670.1	5,699.9	5,927.6	6,127.3	6,433.7
Nominal GDP growth (%)	4.8%	(3.9)%	(1.4)%	(4.0)%	(0.6)%	1.5%	0.5%	4.0%	3.4%	5.0%
Population	64,209	64,395	64,129	63,193	62,408	61,954	61,777	61,735	61,695	61,695
Population growth (%)	0.3%	0.3%	(0.4)%	(1.5)%	(1.2)%	(0.7)%	(0.3)%	(0.1)%	(0.1)%	(0.0)%
Per capita nominal GDP	95,157	90,168	91,305	88,940	89,498	91,521	92,266	96,017	99,316	104,282
Inflation	4.8%	1.8%	2.4%	2.7%	2.4%	1.8%	2.0%	1.5%	1.5%	2.5%
Real GDP growth (%)	0.8%	(5.9)%	(2.5)%	(4.4)%	(4.0)%	(2.0)%	(0.3)%	0.6%	(0.1)%	2.5%
Unemployment	3.0%	4.5%	7.0%	6.0%	8.0%	7.0%	9.0%	7.0%	6.0%	6.0%
Government profit and loss data										
Revenues	928.5	950.8	917.3	996.7	914.2	866.6	883.9	880.4	953.6	988.0
Expenditures	1,064.9	1,194.3	1,126.4	1,245.1	1,142.8	1,092.5	1,183.3	1,145.8	1,115.3	1,169.8
Deficit	(136.4)	(243.5)	(209.1)	(248.4)	(228.6)	(225.9)	(299.4)	(265.4)	(161.7)	(181.8)
Interest expense	17.7	18.2	29.9	56.3	67.6	81.6	109.4	113.5	116.3	120.7
Sinking fund contribution	5.6	9.5	10.3	18.3	25.7	30.8	37.6	47.7	52.3	58.4
Government balance sheet data										
Total debt	345.0	562.2	823.4	1,087.5	1,350.7	1,574.0	2,305.0	2,185.0	2,335	2,484
Sinking Fund balance	(67.8)	(79.8)	(64.5)	(85.5)	(114.7)	(97.1)	(536.6)	(135.8)	(117.3)	(86.0)
Net debt	277.2	482.4	578.9	1,002.0	1,236.3	1,476.9	1,768.4	2,049.2	2,217.7	2,398.0
U.S.$ denominated debt	345.0	415.0	730.0	1,030.0	1,230.0	1,505.0	2,225.0	2,135.0	2,285.0	2,434.0
Guarantees	1.2	0.8	210.8	210.8	207.3	278.6	514.4	700.1	698.1	508.1
Government cash flow data										
Capital expenditures	155.8	200.3	125.1	120.5	59.5	63.5	65.4	49.8	43.7	77.6
Loan proceeds	90	217.2	261.2	264	263.5	223.0	731	(120.0)	150	149
Decrease (increase) in Sinking Fund	9.5	12	(15.3)	21.0	29.2	(17.6)	439.5	(400.8)	(18.5)	(31.3)
Net increase in debt	80.5	205.2	276.5	243.1	234.3	240.6	291.5	280.8	168.5	180.3
Government financial ratios										
Debt service ratio	0.03	0.03	0.04	0.08	0.10	0.13	0.17	0.18	0.18	0.18
Net debt/Nominal GDP	4.5%	8.1%	13.0%	17.8%	22.1%	26.0%	31.0%	34.6%	37.4%	39.1%
Deficit/Nominal GDP	(2.2)%	(4.1)%	(3.6)%	(4.4)%	(4.1)%	(4.0)%	(5.3)%	(4.5)%	(2.6)%	(2.8)%

Chapter 4
Making Government More Efficient

The Case for Efficiency Savings

Current account spending reductions have been increasingly difficult to implement under the current Government structure and the formulaic approach to expenditure cuts used in previous budgets by the former Government. The former Government adopted a reactive, short-term focus to reducing costs by repeatedly targeting operational expenses (e.g. hiring freezes, reducing travel, deferring expenses). Experience from other jurisdictions suggests that such approaches often fail to deliver reductions in expenditure that provide real savings over the medium term. There are five key reasons for this:

1. Costs are shifted, not eliminated – budgetary transfers are made which transfer expenditure from one spending pot to another without reducing the overall cost of service delivery.
2. Arbitrary targets – departments are often directed to reduce expenditure by an overall across-the-board amount and often fail to prioritise, resulting in wholesale uncoordinated cost-cutting that leads to a negative impact on services and morale.
3. Dipping in the same well – a repetitive focus on so-called "low-hanging fruit", such as administrative expenses, which overlooks a real examination of baseline operating expenses where significant opportunities might exist to deliver public services in a more cost-efficient way.
4. Oversight in addressing cost management and controls – reducing expenditure without addressing the overall spending culture.
5. Inability to measure results – without strong monitoring and reporting procedures, it may be difficult to know whether cost-reduction activities are achieving the desired results.

Moving forward, the Government will take a revised approach in order to implement further savings by way of increased efficiencies. To achieve the Government's desire to make the public services more efficient, an Efficiency Team will be created to implement efficiencies across government.

The Efficiency Team will be led by the Junior Minister of Finance. A Steering Group will encompass the Head of the Public Service, the Budget Director, an officer from the Management Consulting Section of the Cabinet Office, and one other member from the Civil Service Executive. The Steering Group will meet and agree the outline plan for the efficiency reviews and detailed management and resource arrangements. The process will comprise a number of reviews, which will be completed in phases during the course of the next fiscal year.

A key factor in improving public sector efficiency will be how to use technology to better deliver government services. The Government will make investments in technology in the near term to reduce expenses in the future.

Chapter 5
Broadening our Tax Base

Tax Reform

The Government considers tax reform to be one of the most important things required for us to build a sound foundation for growth and to reduce the cost of doing business in Bermuda. Our current system needs reform not only to reduce the cost of doing business and to encourage job growth in Bermuda, but also because our current system of taxation exacerbates inequality, which in turn reduces economic growth. Accordingly, the Government's 2017 General Election Campaign Platform pledged to:

> *"Create a **Tax Reform Commission** (TRC) drawing participants from both political parties, international business, local businesses, trade unions, hoteliers, academia and the Bermuda Bar. Its mission will be to conduct a review of our system of revenue collection and taxation and to make recommendations to parliament on revenue and tax reform that make our tax system fairer and enhance Bermuda's international competitiveness to increase the number of jobs based in Bermuda."*

The Government's reason for establishing the TRC is that we strongly believe that tax reform cannot, and should not, be a one-party endeavour, as substantive tax reform must have the widest possible input.

The Tax Reform Commission Act 2017 has been passed in the Legislature and the members of the Commission will be announced shortly.

In their recent report, the Fiscal Responsibility Panel noted: "We believe that over the longer term the revenue share will have to rise from its current level of around 17% GDP to a level nearer the 22–23% share seen in comparable small island economies; this will be necessary both to ensure a stable and robust fiscal position and to accommodate future expenditure pressures. The work of the Tax Reform Commission is thus critically important."

The overarching principles to guide the TRC's efforts in preparing recommendations are as follows:

- To ensure the tax system is fairer and more equitable.
- To ensure the tax system enhances Bermuda's global competitiveness.
- To ensure that the tax base is broadened in order to reduce the reliance on payroll taxes.

- To ensure simplicity and transparency in the tax system in order to reduce the cost of administration and promote compliance.
- To ensure greater compliance in tax collection.

The TRC will also be mindful of the five desired traits of any tax system:

1. The first trait is a stable revenue yield, so that Government can meet its social and fiscal obligations.
2. The second trait is the provision of a reasonable overall tax burden on all economic agents: persons and business would prefer not to have to pay taxes in order to be able to dispose of all their income as they see fit. Yet they wish to benefit from government programs, and so they view taxes as a "necessary evil". However, there is an upper range with which persons and business in each country are willing to comply. Trying to achieve a revenue yield or tax burden above this range will generally not be successful.
3. The third trait is for the tax system to be compliance-promoting (simple/transparent/fair). The underlying objective here is to encourage compliance.
4. The fourth trait is for the tax system to be growth-promoting: efficient/neutral/non-distorting. A growth-friendly tax system is efficient (neutral) in that it does not alter relative factor prices and costs, and therefore it does not provoke "different decisions" (or a different allocation of resources) in the economy from those that would have been made in the absence of taxes.
5. The fifth trait is for the tax system to be equitable: "tax payers who can afford to are asked to pay more than those who cannot afford to".

Chapter 6
Conclusion

Commitment to Budget Transparency

This Pre-budget Report represents a step forward in the preparation of budgets and the formulation of budget policy in Bermuda. To meet international best practice for budget transparency, the International Budget Partnership recommends that governments publish eight budget reports during the budget cycle. The documents and the governments' commitments are below:

1. **Pre-budget Report:** This document is the Government's second Pre-budget Report. It is recommended that this document be issued at least one month prior to the Budget Statement to allow adequate time for public feedback to assist in budget policy formulation.
2. **Budget Statement:** The Government issues budget statements annually. This practice is a matter of custom and will continue.
3. **Citizens' Budget:** A Citizens' Budget is a non-technical presentation that "can take many forms but its distinguishing feature is that it is designed to reach and be understood by as large a segment of the population as possible". A Citizens' Budget is a simplified summary of the budget designed to facilitate discussion. The Government has issued a guide to the budget in the past and will issue this document with the 2018/19 Budget Statement.
4. **Enacted Budget:** The enacted budget is the appropriations bill which is passed by the legislature annually, as required by the Bermuda Constitution.
5. **In-year Reports:** The Government currently issues quarterly fiscal performance reports and will continue to do so.
6. **Mid-year Review:** The Government currently issues a Mid-year Review and will continue to do so.
7. **Year-end Report:** The Government does issue financial statements once they have been audited as per the Bermuda Constitution. The Government also provides highlights of the Financial Statements by way of a Ministerial Statement in the House of Assembly. The Government commits to developing and releasing a more comprehensive report by way of a Financial Statement Discussion and Analysis document at the same time as its annual financial statements.
8. **Audit Report:** The Auditor General currently issues an Audit Report annually.

It is the aim of the Government to provide all of these reports during the coming budget cycle and 2018/19 fiscal year. In publishing this document and conforming to international standards of budget transparency, this Government reaffirms its commitment to good governance.

Feedback

The Government invites and welcomes feedback on this document. In addition to electronic communication, the Government will hold public meetings in January 2018 to discuss the principles laid out in this document and to solicit public feedback.

Comments can be emailed to: openbudget@gov.bm