

ADDRESSING THE CHALLENGE OF FISCAL SUSTAINABILITY
OF THE
CAYMAN ISLANDS:

FINAL REPORT
OF
THE INDEPENDENT COMMISSION

February 26, 2010

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Executive Summary

This report is in response to an initiative by the Premier of the Government of the Cayman Islands (undertaken at the recommendation of the U.K.'s Foreign and Commonwealth Office) to enlist a three-person, independent commission to assess the Government's fiscal challenges and to make recommendations. The Commissioners began work in mid-November 2009, submitted an interim report to the Premier on December 31st, and now proffer this final report.

The report was written by Mr. Miller and Mr. Shaw. During the course of our work, we relied on documents supplied to us by Mr. Jefferson, information available over the Internet, and materials otherwise at hand. We also visited the Islands (January), met with various Government officials and leaders in the private community, and subsequently received additional materials useful for our work.

Major Conclusions:

1. The Cayman Government's fiscal performance was acceptable until recently, when growth in spending outran growth in revenues.
2. The Cayman Government is on a path that is no longer fiscally sustainable.
3. The Cayman Government has huge unfunded liabilities -- specifically its civil servants' defined-benefit retirement and healthcare plans.
4. Personnel costs are crippling the Cayman Government's ability to restore its fiscal balance and by any reasonable standard are excessive and unsustainable.
5. The Cayman economy and its Government's revenue are highly dependent on the financial services and tourism industries, and additional levies on either would likely be counterproductive.
6. It should be possible for the Cayman Government to restore and maintain fiscal sustainability by undertaking major cuts in spending, by privatizing enterprises, and by selling other assets.
7. The Cayman Government can improve its efficiency and effectiveness in a number of ways, ranging from completing audited financials to reforming the budget process to make it more transparent and to make officials more accountable.
8. Significant opportunities exist for the Cayman Government to enable the private sector to supply needed investments in the Islands' infrastructure and to develop and broaden the economy's base.

Major Recommendations:

1. Do not impose direct taxation.
2. Orchestrate substantial privatization and other asset sales.
3. Make significant reductions in operating expenses.
4. Develop and maintain a separate contingency fund.
5. Complete audits of all Government agencies, Statutory Authorities, and State Owned Enterprises.
6. Reform the budget process to improve transparency and increase accountability.
7. Improve the accuracy, reliability, and usefulness of data produced by the Economics and Statistics Office.
8. Review Government activities to identify and implement efficiency-enhancing applications of information technology, related reforms, and contracting out.
9. Study ways of raising the same revenue but minimizing the adverse effects on economic activity of various levies on the financial services industry, the tourism industry, and the goods and services industry.
10. Attract private capital to solve various infrastructure challenges and to develop new enterprises.
11. Increase the number of work permits, reduce work permit fees, and make the guest worker program more flexible.
12. Eliminate the tax on funds exported from the Islands, to lessen the inequity and to quell rumors that the Caymans may well tax other types of fund transfers.

I. Introduction and Acknowledgements

At the end of October, 2009, the Honorable W. McKeeva Bush, Premier-Designate of the Cayman Islands, established a three-person independent commission to analyze the fiscal problems facing the Cayman Islands Government (or henceforth, simply "Government"). He asked three financial experts -- James C. Miller III, David Shaw, and Kenneth Jefferson -- to serve as commissioners, with Mr. Miller to serve as chairman. All three accepted the assignment. After some preliminary discussions over scope and content of the effort, including a meeting between Premier Bush and Mr. Miller in mid-November, serious work began. As Premier Bush announced soon thereafter, an interim report by the Commission would be completed by year's end, but the Commission's final report would be issued sometime in February.¹ The Commission presented its interim report to Premier Bush at the end of December and now presents this final report.²

Establishment of the Commission was in response to a recommendation to Government from the U.K.'s Foreign and Commonwealth Office.³ Although the major focus of the Commission is to "undertake a professional assessment of the options for, and the potential impact of, new revenue sources, including direct taxation and other proposals which would significantly diversify and improve the current revenue base of the Government,"⁴ the stated Terms of Reference for the Commission's work are broader.⁵ They include an analysis of spending, deficits, debt, and vulnerabilities to revenue and spending caused by the Islands' unique geography and economy. The Commission was also tasked with drawing conclusions, making recommendations, and presenting these in an appropriate manner.

The three Commissioners bring varied and complementary perspectives to the work of the Commission. Mr. Miller, a professional economist, served as President Reagan's budget director, as a Member of the President's Cabinet, and as a Member of his National Security Council. Mr. Shaw is a chartered accountant by profession, and as a U.K. Member of Parliament was involved in committees covering finance, taxation, smaller businesses, social security, and the regulation of social security and pensions.

¹ See "Tax Review Delay News to UK," Cayman News Service, November 20, 2009.

² This final report is consistent with, and in part draws upon, the interim report.

³ See letter from Hon. McKeeva Bush to Mr. Colin Roberts of the U.K. Foreign and Commonwealth Office, October 30, 2009.

⁴ Letter from Hon. McKeeva Bush to Mr. James C. Miller III, October 29, 2009, p. 1.

⁵ The Commission's Terms of Reference are set out in Appendix A.

He also has considerable experience in private business. Mr. Jefferson is currently Financial Secretary with the Portfolio of Finance and Economics of the Cayman Islands Government. He too is a chartered accountant by profession, having worked in accounting in both London and the Cayman Islands.⁶

Commissioner Jefferson facilitated greatly the work of the other two Commissioners by providing various materials that were requested. But the Report was written by Commissioners Miller and Shaw, and they alone -- not Commissioner Jefferson -- should be held responsible for the contents of this final report.

In the course of its work, the Commission consulted with several experts on fiscal issues with specific knowledge of the Caymans, its economy, and its Government's financial problems. Three such experts -- Mr. Scott Hodge, Dr. Daniel Mitchell, and Dr. Ronald Utt -- made key contributions and wrote text that is included in the report.⁷

The Commission also visited Grand Cayman and interviewed a number of Government officials and leaders in the private sector.⁸ The perspectives and other information obtained during this process was a fundamental part of the Commission's work. The willingness of persons to devote their time -- sometime hours -- is very much appreciated.

Finally, the Commission's research was enabled by access to a number of essential documents. Much of the Government's financial database (for example, Strategic Policy Statements and Annual Budget Estimates) is available on the World Wide Web.⁹ As noted earlier, the Commission was helped also by responses to questions posed by Commissioners Miller and Shaw in written and verbal communications with the Office of the Financial Secretary.

The Commission's work was completed in a fairly short period of time. Consequently, despite best efforts, this report may contain errors of both omission and commission. It is hoped that any such shortcomings will not detract from the Commission's overall assessment of serious challenges to fiscal stability faced by the Government, the conclusions that are drawn, and the recommendations that are made.

⁶ Brief biographies for all three Commissioners can be found at Appendix B.

⁷ Brief biographical information on these three experts is contained in Appendix C.

⁸ A list of persons interviewed can be found in Appendix C.

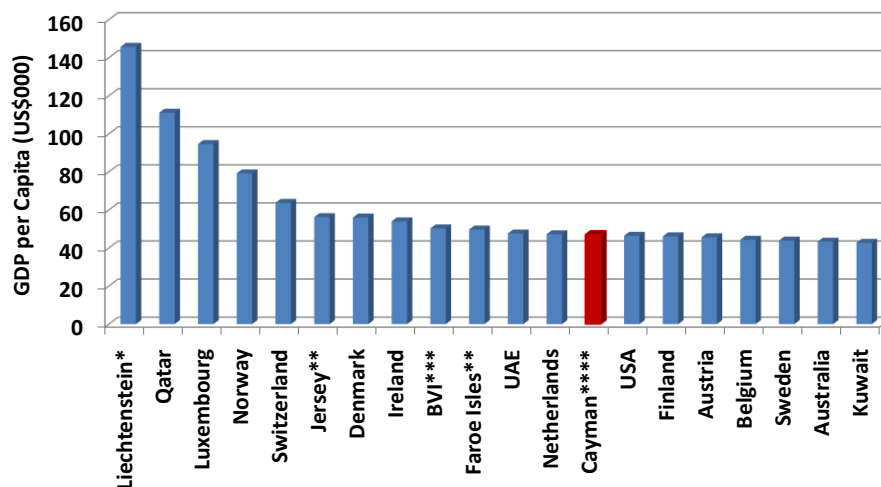
⁹ We realize that these numbers are updated from time to time, as financial reports are audited and as other refinements are made. But we believe the material presented in this report -- the latest available -- is reasonably accurate and appropriate for our purposes.

In making our inquiries and in writing this report, we have held in highest regard the long-term interests of Caymanians. In that context, we have sought solutions that will protect and develop further the key economic and social drivers of the Cayman Islands.

II. Overview of Cayman Government's Fiscal Performance

As shown in Figure 2-1, Cayman is one of the world's most prosperous economies, ranking in the top 20 by GDP per capita.

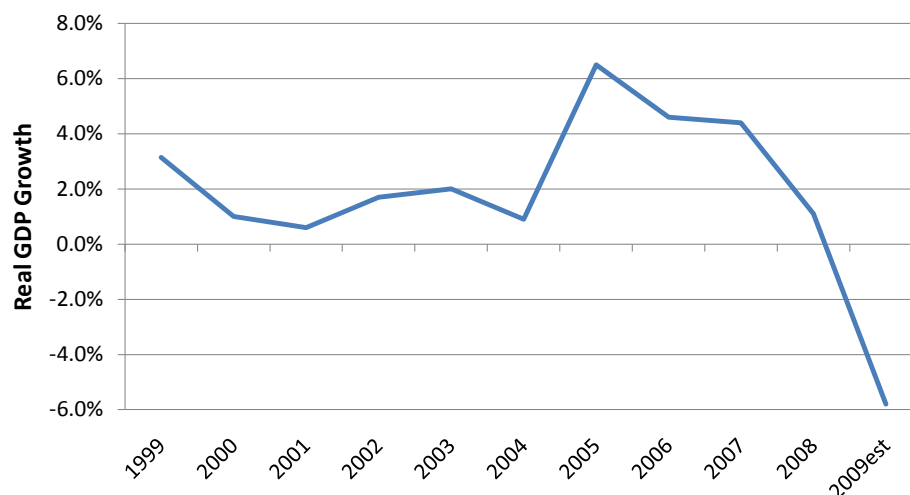
**Figure 2-1: Economies with Highest Living Standards
Ranked by GDP per Capita (2009)**



Note: Data are 2009 estimates unless otherwise indicated: * 2007; ** 2003; *** 2005 est; **** 2008 est
UK GDP per capita for 2009 estimated to be \$36,000
Source: CIA World Factbook

As shown in Figure 2-2, GDP growth in the Cayman Islands has been variable in recent years, and GDP is estimated to have declined in 2009 as a result of the impact of the U.S. economic and financial crisis.

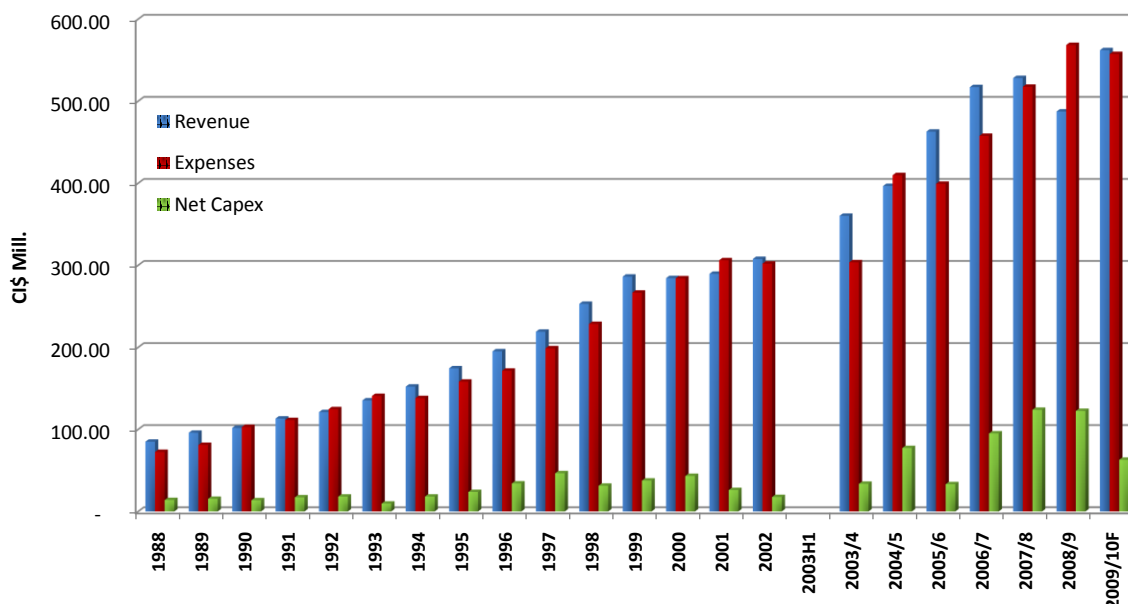
Figure 2-2: Real GDP Growth in the Cayman Islands



Source: Offering Memorandum for 5.95% Notes due 2019, dated November 19, 2009

Core Government revenues and expenditure have both grown considerably in recent years, as shown by the 20-year trend in Figure 2-3.

Figure 2-3: Cayman Islands Core Government Receipts and Payments



Note: Expenses include interest expense and extraordinary costs.

While the revenue burden is relatively low in the Caymans, the long-term trend has been toward substantial increases. This is partly the result of reasonably strong economic performance, but also because of periodic increases in duty rates, fees, and other charges by Government. In the past 20 years, annual revenues have risen rapidly -- from about \$100 million to more than \$500 million.¹⁰ Available data on economic output is less precise, but rough estimates indicate the burden of Government revenues rose by about 5 percentage points of GDP during that time period.

The spending side of the fiscal ledger shows an even more pronounced pattern. In nominal terms, spending is now about seven times what it was two decades ago. But to put these numbers in context, there has been some inflation, substantial population growth, and the economy has expanded considerably. This is why spending as a share of economic output is the most relevant measure of the fiscal burden. But for the Cayman Islands, this does not yield encouraging results. The public sector consistently has grown faster than the private sector in recent years, which is an unhealthy and unsustainable fiscal pattern.

¹⁰ In nominal terms -- unadjusted for inflation and population growth.

Revenues

The current sources of revenue for core Government functions are shown in Table 2-1.

Table 2-1: Sources of Revenue

	Actual 2008/09 CI\$m	Budget 2009/10 CI\$m	Average Annual Growth Rate 4 years to 2010
Nominal GDP	2,626.7	2,538.7	2.2%
Total Levies on Intl. Trade and Transactions	166.6	170.1	0.3%
Total Domestic Levies on Goods/Services	238.7	314.3	11.6%
Property and Court: fees	32.7	29.1	-8.1%
Total Coercive Revenue	437.9	513.5	5.7%
Other revenue incl. sales	49.5	48.8	-1.2%
Total Operating Revenue	487.4	562.2	5.0%

Some important observations:

- Duties are charged on most imported goods, with exemptions for essential foodstuffs and certain special classifications. Higher-duty rates apply for luxuries and higher-value automobiles.
- Domestic levies on goods and services include financial and corporate registrations as well as licenses. These levies are applied to all relevant private businesses, but most of the revenue comes from the financial services sector. The tourism sector contributes under this category through a charge on tourist accommodations, fees for business registrations, and tourist transport.
- Revenue from property is in the form of a transfer duty on transactions in land and buildings.

The 11.6 percent average annual increase in “domestic levies” reflects the “squeeze” that has been applied on the private business sector by the Cayman Government over the last four years. Under this category revenues have increased from CI\$202 million to CI\$314 million. Approximately 60 percent of this increase results

from an emergency budget in October 2009, and it is not yet certain that all the budgeted revenue increases will be collected.¹¹

Table 2-2 shows that duties on imports have not kept pace with GDP in recent years:

Table 2-2: Revenues from Imports

	Actual 2005/06 CI\$m	Actual 2006/07 CI\$m	Actual 2007/08 CI\$m	Actual 2008/09 CI\$m	Budget 2009/10 CI\$m	Average Annual Growth Rate
Nominal GDP	2,322.6	2,476.2	2,633.5	2,626.7	2,538.7	2.2%
Revenues - Imports						
Other Import Duty and Charges	98.8	115.5	108.6	100.3	103.9	1.3%
Gasoline and Diesel	18.5	24.1	23.4	22.9	21.8	4.2%
Alcoholic Beverages	15.8	15.9	15.9	15.7	16.5	1.1%
Motor Vehicle Duty	15.4	12.1	13.5	11.3	11.4	-7.3%
Cruise Ship Departure Tax	11.0	11.6	9.4	8.9	9.0	-5.1%
Environmental Protection Fees	5.3	5.5	4.8	4.4	4.0	-6.9%
Tobacco Products	3.4	3.1	3.2	3.2	3.6	1.2%
Total Levies on Intl. Trade and Transactions	168.3	187.9	178.9	166.6	170.1	0.3%

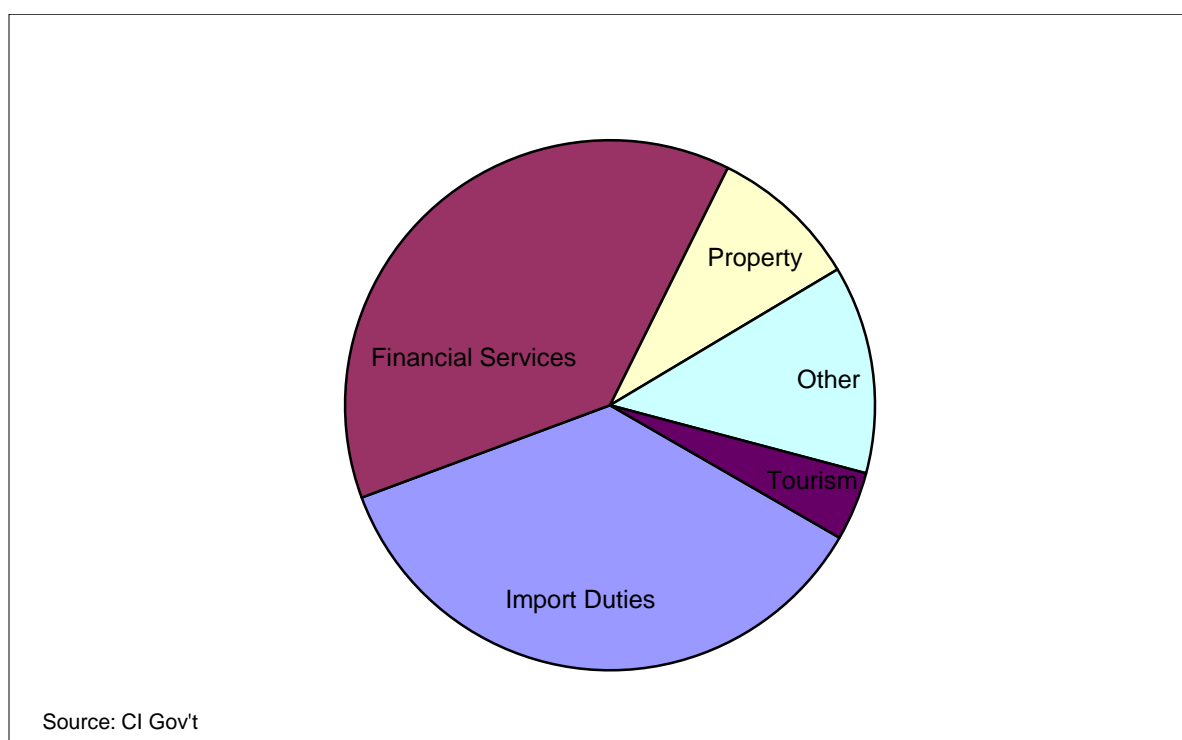
The fact that import duties have declined relative to GDP may indicate collection problems and possible avoidance and even evasion. This matter deserves to be investigated.

More than three-fourths of Government revenue is generated by import duties and levies on the financial services industry. As an island economy that must rely on imports, the role of customs duties is not surprising. Indeed, in such a situation import duties could be considered as being roughly akin to a general consumption tax on goods (though not on services). The substantial revenue generated by the financial services industry also is not surprising, since the Cayman Islands is the world's sixth-largest financial center. Tourism accounts for a relatively small share of Government revenue directly, but generates substantial income for the Islands generally. Moreover, tourism drives a substantial flow of imports, and thus indirectly accounts for substantial Government revenue.

¹¹ Just prior to submission of this report, we were informed that \$15 million of potential revenue from a new charge would not be approved by the Cabinet and so would not be implemented. This followed representations by the business community that this particular initiative would be so burdensome as to be counterproductive.

Despite the lack of revenues from duties and the fall-off in revenues derived from real estate transactions, Government's revenue growth over the four years to FY2009/2010 is averaging a relatively strong 5 percent per annum. At that level of annual increase, Cayman Islands' problems cannot be seen as resulting from a shortage of revenue.

Figure 2-4: Contributors to Government Revenues



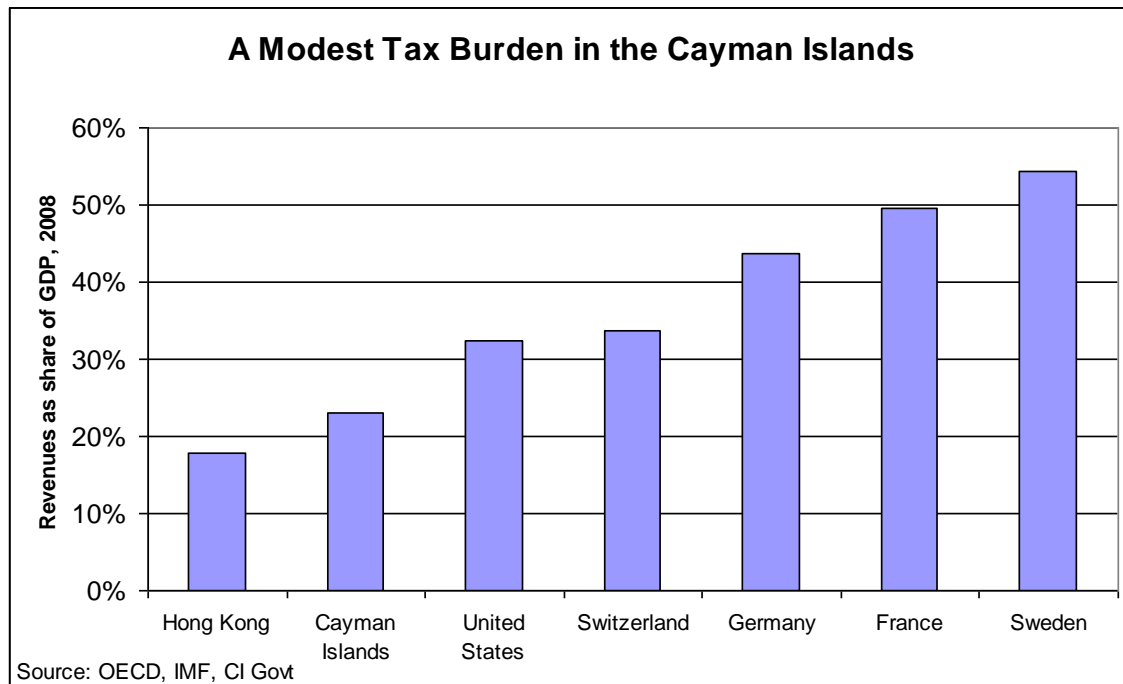
While the Cayman Government has increased various levies in recent years, none of these measures could be characterized as a major shift in policy. The relative shares from major revenue sources have changed modestly this decade. Customs duties have declined slightly since 2000, as have tourism revenues. Collections from the financial services industry, by contrast, have generated a somewhat larger share of revenue.

The Cayman Islands enjoy a modest burden of government compared to most nations. Revenues consume less than 25 percent of economic output, roughly comparable to jurisdictions such as Singapore, Hong Kong, and Liechtenstein.¹² Most

¹² Technically, revenues and taxes are not identical. Governments sometimes distinguish between tax receipts, which are coerced payments, and non-tax receipts, which usually result from voluntary transactions. For purposes of simplicity, that distinction is overlooked in this comparative analysis.

developed nations, by contrast, divert larger shares of output to government, while some Nordic nations top the charts, with governments in Denmark and Sweden taking more than 50 percent of economic output.

Figure 2-5: Comparison of Revenue Burdens



Expenditures

Core Government operating expenses compared to GDP are shown in Table 2-3.

This table shows that core Government expenditure has grown over four years at an average annual rate of 9.0 percent. This is far faster than the growth of GDP, which increased at an average annual rate of 2.2 percent over the same period.

Table 2-3: Core Government Operating Expenses

	Actual 2005/06 CIS\$m	Actual 2006/07 CIS\$m	Actual 2007/08 CIS\$m	Actual 2008/09 CIS\$m	Budget 2009/10 CIS\$m	Average Annual Growth Rate
Nominal GDP	2,322.6	2,476.2	2,633.5	2,626.7	2,538.7	2.2%
Operating Expenses						
Personnel Costs	172.4	206.9	215.6	252.3	244.0	9.1%
Supplies & Consumables	102.8	108.7	118.1	94.4	103.3	0.1%
Depreciation	9.5	13.4	15.3	17.9	20.5	21.3%
Outputs from Public Authorities	62.9	74.5	87.2	103.0	98.6	11.9%
Outputs - Non-Governmental Organizations	6.9	12.4	22.0	21.7	22.4	34.1%
Transfer Payments	16.7	17.9	21.9	31.9	32.0	17.7%
Other Opex	1.0	3.3	7.0	4.7	4.3	42.7%
Net Deficit in Public Authorities	4.2	9.5	16.6	11.4	6.7	12.9%
Total Operating Expenses	376.3	446.7	503.8	537.4	531.9	9.0%

Table 2-3 also shows the significance of Government personnel costs, which last year (FY2008/2009) accounted for 47 percent of operating expenses, and which increased over the period at over four times the rate of growth in the economy. Furthermore, personnel costs increased at a 9.1 percent annual rate, whereas Government revenues increased only 5 percent annually in the corresponding period.

In Figures 2-6 and 2-7, we show growth of total Government payroll costs (including the Statutory Authorities and State Owned Enterprises) compared with growth in the economy and the major business sectors -- all indexed to FY2004/2005.

Figure 2-6: Tourism Volumes Compared with Economic Growth and Government Personnel Costs (Indexed to 2004/2005 = 100)

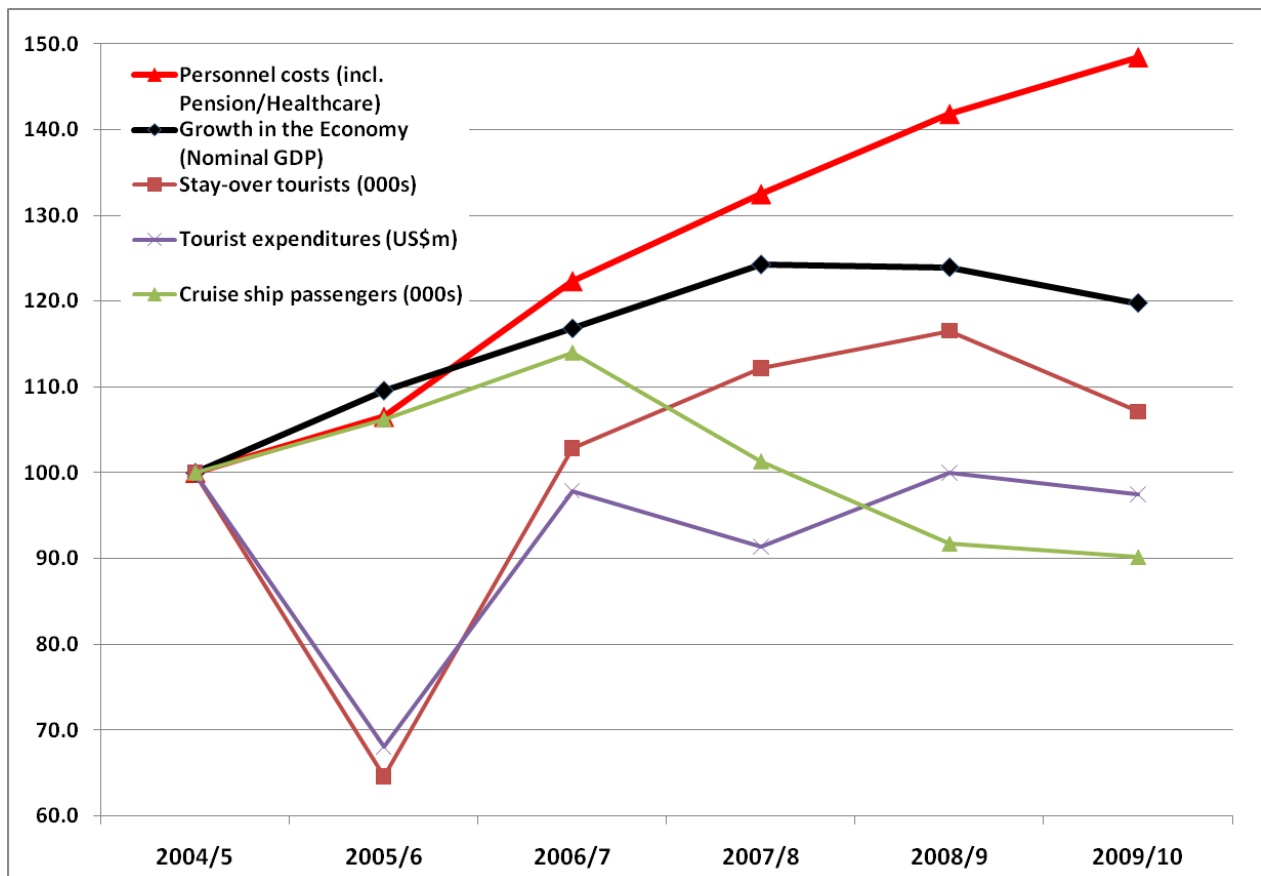


Figure 2-6 shows that tourism trade volumes have been falling but that Government personnel costs continue to rise at a rate faster than the rate of economic growth.

**Figure 2-7: Growth in Government Personnel Costs
Compared with Growth in Financial Services Volumes and Growth in GDP
(Indexed to FY2004/2005 = 100)**

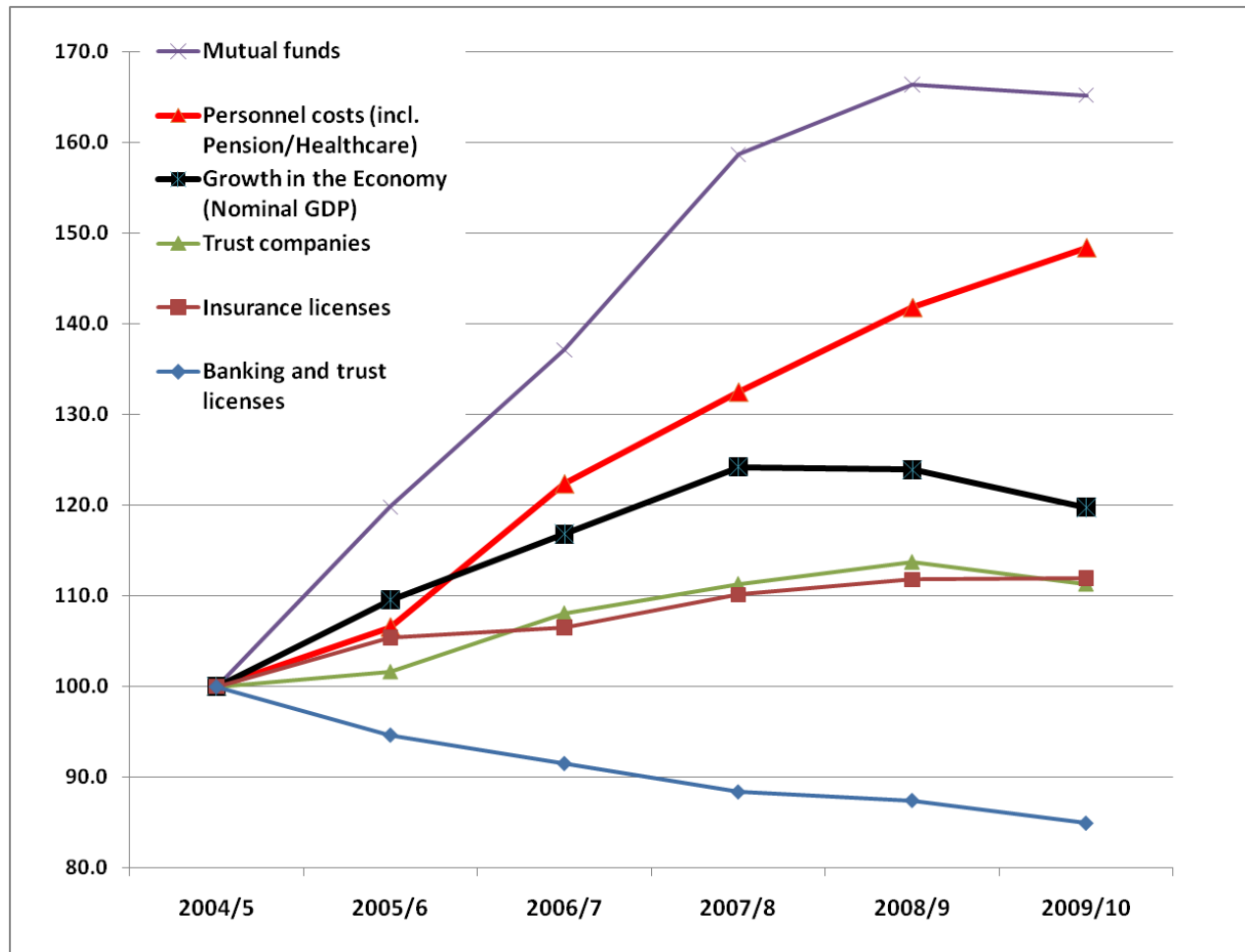


Figure 2-7 shows that Government personnel costs have increased at a faster rate than all financial-sector volumes other than mutual funds, and that the number of banking and trust licenses has actually been falling. There has been an exceptionally large increase in the number of mutual funds registered over the last five years. However, these are now contracting in numbers, and fund managers and directors do not anticipate any growth in numbers for some years, if at all.

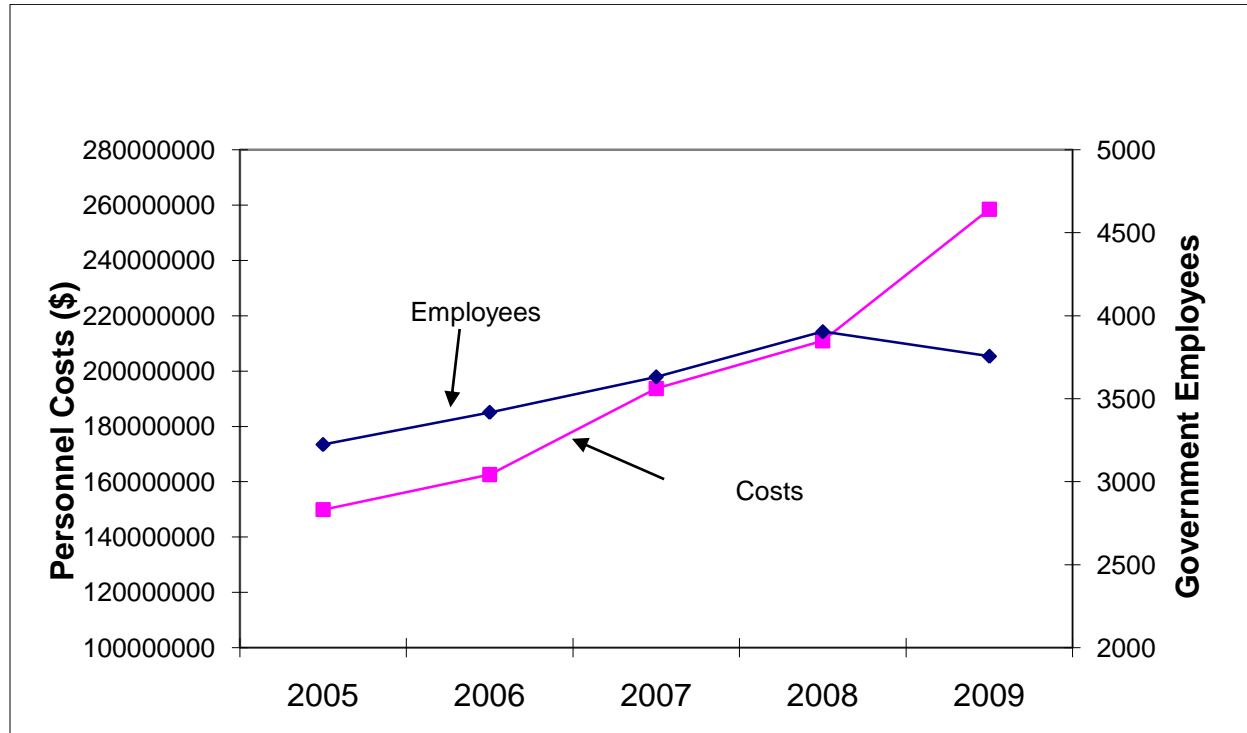
Figures 2-6 and 2-7 also show that all the key financial-services indicators have been flat or falling in the last year and that some have been falling for a number of years. The only business indicator that remains above personnel costs is the number of mutual funds, and even that one area of business is beginning to decrease while personnel costs continue to rise.

In summary, the private business sector indicators are not favorable to providing Government with more revenues. For policymakers to presume that economic recovery will mean continued expansion in the volatile hedge-fund industry would be a mistake.

Government spending (partly as a result of an expanded capital program) now consumes about 28 percent of economic output in the Caymans, according to the International Monetary Fund. This is significantly higher than in other jurisdictions such as Hong Kong and almost as high as in Switzerland, but is lower than in the principal Organization for Economic Cooperation and Development (OECD) nations. This gap, however, should not provide too much solace to Caymanian policymakers. Nations with large internal markets and diversified economies are probably better positioned to endure larger levels of government. Large public sectors in places such as the Caymans, by contrast, could bend to fiscal pressures that lead to even greater burdens that run the risk of threatening their economies.

The high level of spending in Cayman bears an unfavorable comparison to Hong King and Switzerland as well as many other countries, because many of those other countries spend 3 percent to 6 percent of GDP on defense. The United Kingdom is responsible for Cayman's defense.

Figure 2-8: Rising Number and Costs of Government Employees



The rapid expansion in the size and cost of the civil service is the main reason for the continued growth of Government spending. As shown in Figure 2-8, total

spending on personnel costs has jumped dramatically since 2005. The number of Government employees also has increased, but at a slower pace.

Moreover, there is a bit of a boom-bust fiscal pattern in the Cayman Islands. When the economy is strong and tax receipts are buoyant, there is a tendency to spend the additional revenue. Spending rose rapidly in the late 1990s, for instance, growing by an average of 14 percent per year. The same pattern took place in recent years, with Government spending growing rapidly in the middle part of the decade.

Unfortunately, the boom years always come to an end. This means revenues stagnate. But governments usually do not do a very good job of predicting downturns, so spending continues to climb, thus creating large budget deficits. This can create a fiscal crisis, and policymakers are then put in a position of having to make dramatic changes.

The key question, of course, is what type of changes policymakers select. As illustrated in Figure 2-9, both spending and revenues now consume a larger share of GDP than they did five years ago. The budget shortfall in the Cayman Islands exists because spending grew even faster than revenue. The choice for policymakers, therefore, is whether spending should be constrained so that natural revenue growth allows for long-term balance, or whether the revenue burden should be increased in an attempt to “catch up” to spending.

Figure 2-9: Rising Levels of Government Spending Relative to Revenue

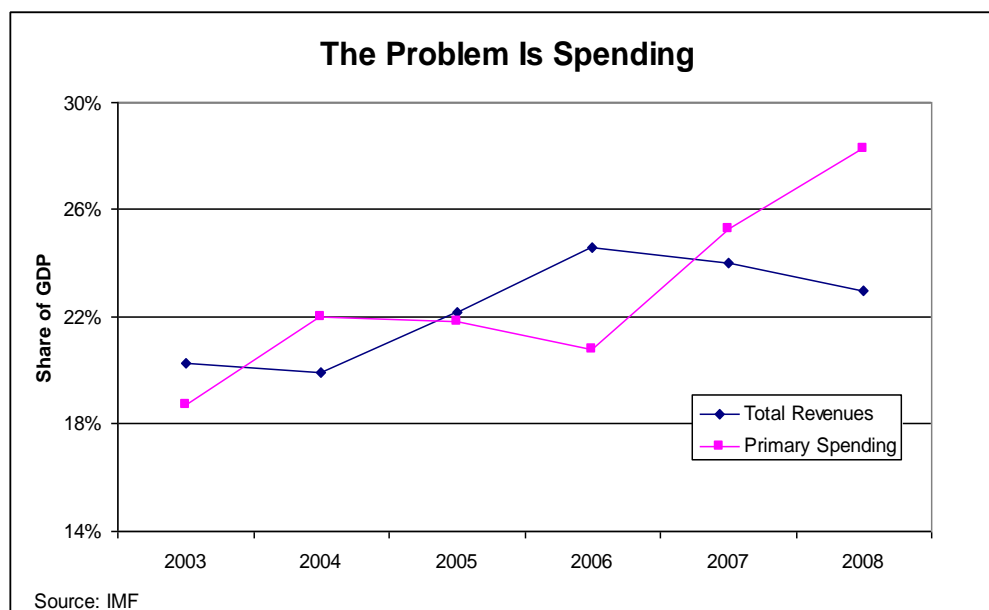


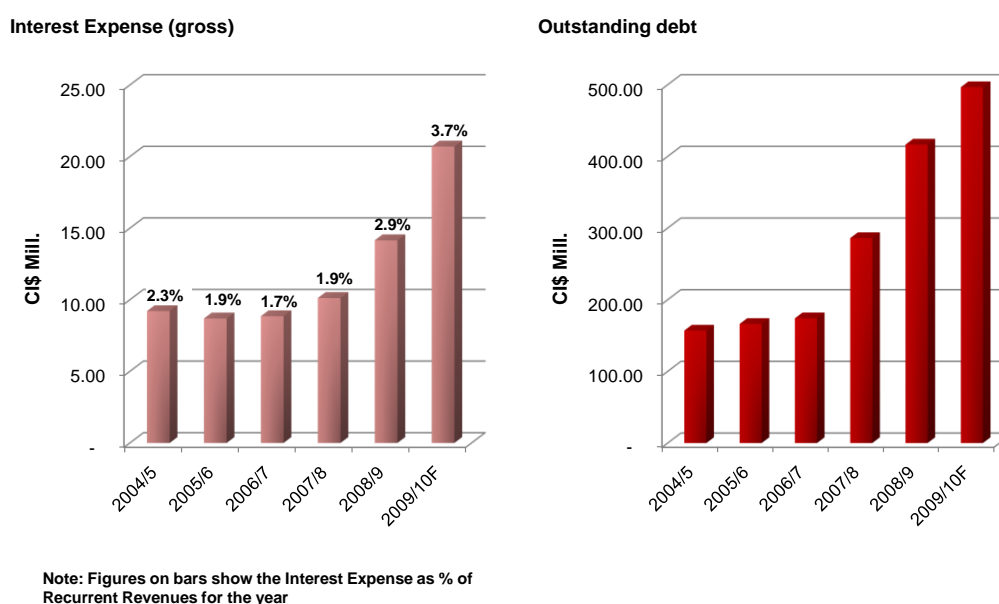
Figure 2-9 also underscores another important point. Economic growth matters. There are two ways to reduce government spending as a share of GDP. The first way is

to cut government spending. The second way is to increase economic output. Indeed, the key factor in fiscal restraint – at least in normal circumstances – is simply to make sure that government spending does not grow faster than overall economic output.

Interest Payable

The previous paragraphs showed that Government spending on day-to-day operations in the Caymans is rising at a far faster rate than either operating revenue or economic growth. The result is that the Government is being forced to borrow not just for its capital program but also to meet normal operating expenses. This is the first step on the path to budgetary unsustainability. The nearness to such instability is illustrated by the rapidly-rising interest expense shown in Figure 2-10.

Figure 2-10: Cayman Islands Core Government Interest Expense and Debt



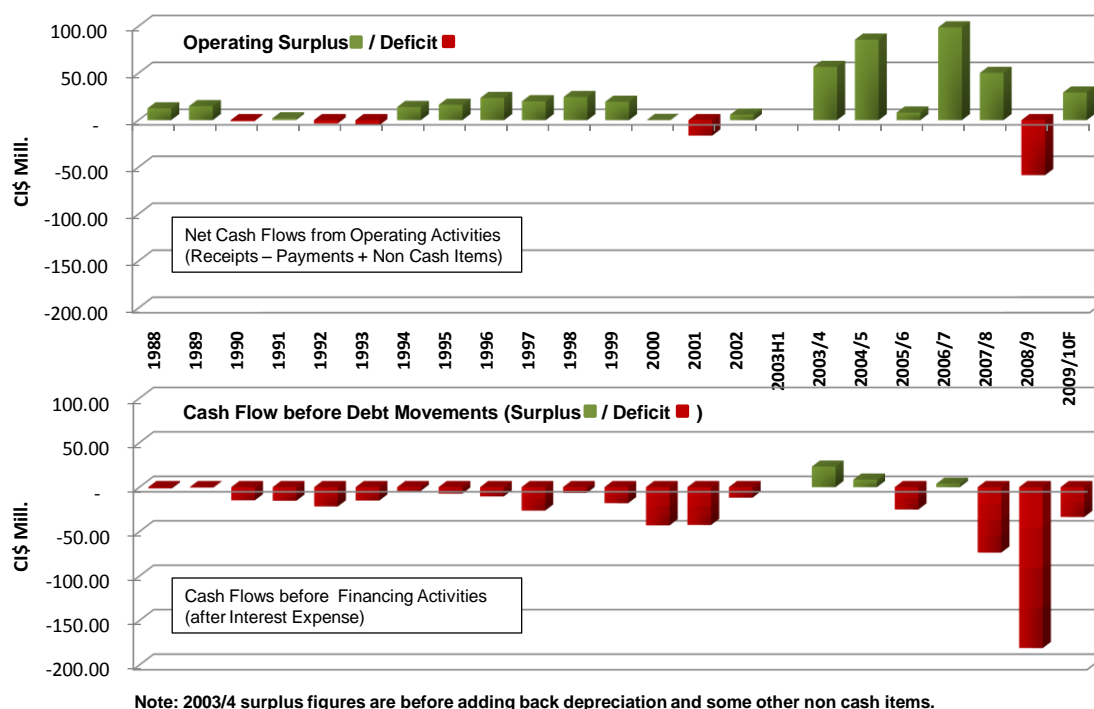
This increase in interest costs is mirrored by the rise in outstanding debt.

Surpluses and Deficits

Cayman's operating surplus before capital expenditures has been positive in most years over the last 20, as shown in the upper part of Figure 2-11. However, these operating surpluses have been relatively small apart from two years. Consequently, recourse to borrowing has been necessary to fund the capital program, whereas prudence would have placed more emphasis on acquiring capital projects through revenue surpluses.

The lower part of Figure 2-11 shows that cash flow after capital expenditure has been negative in almost all of the last 20 years, with sizeable deficits in the last three years, particularly in FY2008/2009. The debt burden has grown substantially over this period.

Figure 2-11: Cayman Islands Core Government Surpluses / Deficits



Realistic Budget Projections

The very nature of budget projections means that few have a high degree of accuracy. A significant part of Government's revenues are dependent on the level of activity in the economy, hence forecasting the revenue side of the budget is challenging. The spending side of the fiscal ledger, by contrast, should be easier to predict and control -- especially in Cayman, where around one-half of Government expenditure consists of personnel costs.

Figures 2-12 and 2-13 demonstrate the forecasting record in Cayman. In the most recent years, the Government has predicted less revenue than it actually received. In earlier years, it predicted more. The main exception to this was FY2008/2009, where revenues fell off dramatically because of the global economic contraction. Since economists do not do a very good job predicting how fast the economy will grow, the important test for the Government is whether there is a pattern of excessively optimistic to the revenue forecasts. This appears not to be the case for the Cayman Islands.

Figure 2-12: Forecast vs. Actual Recurrent Revenues¹³

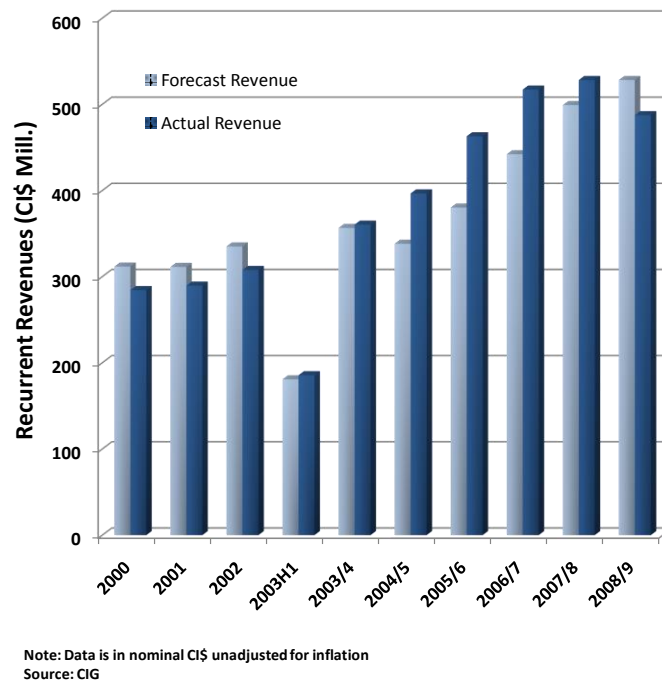
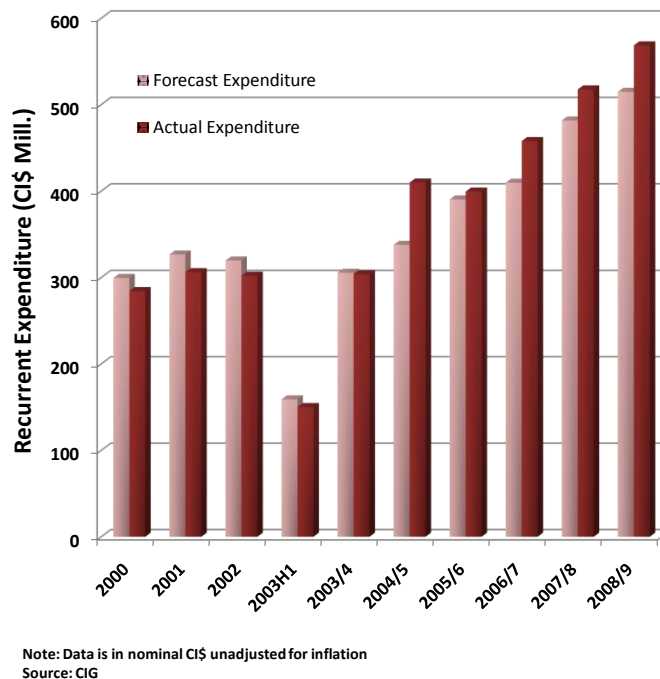


Figure 2-13: Forecast vs. Actual Recurrent Expenditures¹⁴

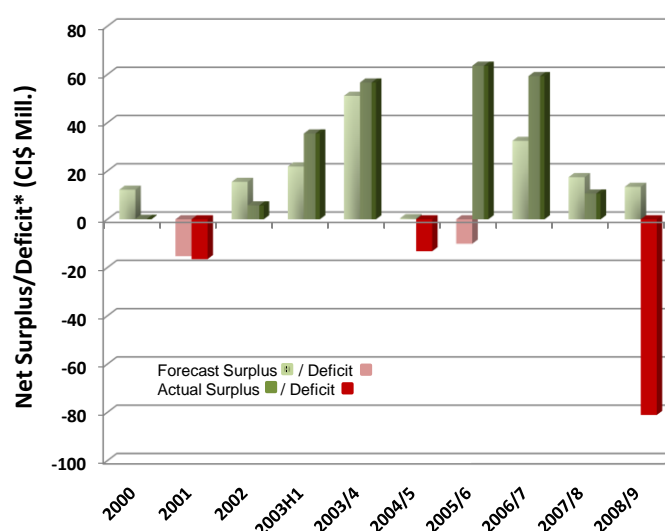


¹³ Recurrent revenues are referred to elsewhere as operating revenues. Both definitions are used by the Cayman Islands Government.

The spending side of the fiscal equation, however, tells a different story. For the past five years, there has been a noticeable pattern for the Cayman Government to spend more than originally forecast. This is particularly worrisome, since spending should be much easier to predict and control. The Cayman Islands does not have a large welfare state with “entitlement” programs that automatically expand if the economy falters.

The result of these revenue and expenditure patterns has been that in some years the actual surplus or deficit has differed markedly from the forecast figures. Figure 2-14 shows the operating surplus/deficit before non-cash items and before capital expenditures. The forecasting problem was particularly pronounced in FY2008/2009, when the forecast surplus of CI\$13.5 million turned into an actual deficit of CI\$81.1 million.¹⁵

Figure 2-14: Forecast and Actual Surplus / Deficit



Note: Data is in nominal CI\$ unadjusted for inflation. *Surplus/Deficit is before accounting for non-cash items.
Source: CIG

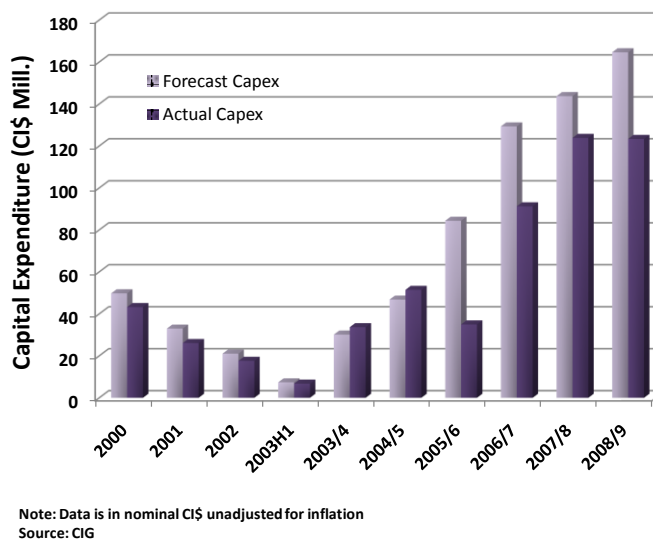
Over the last four years since FY2005/2006, actual capital expenditures have been significantly below forecast levels, as show in Figure 2-15. This is a common experience of governments, since-public sector infrastructure projects generally take longer than planned. This nearly always results in less expenditure in the year than was originally budgeted. This under-spend is often misinterpreted and leads to political

¹⁴ Recurrent expenditure is the sum of operating expenses (plus statutory expenditure prior to FY2003/2004) plus net non-operating revenue and expenses.

¹⁵ It should be noted that a small improvement to this deficit is anticipated when the audited accounts are completed.

demands for new projects and further expenditure commitments. This can lead to a situation in which, just as the economic situation worsens, the government finds it is committed to a capital program it cannot afford without recourse to urgent new borrowing. The tendency toward under-forecasting expenditures exacerbates the borrowing problem caused by over-commitments on capital projects. This dual pressure on borrowing has occurred in Cayman.

Figure 2-15: Forecast vs. Actual Capital Expenditures



Borrowing

Dramatic increases in spending, combined with a limit on the private sector's ability to finance more Government, has led to more borrowing. In the next chapter, we examine the ramifications of such fiscal imbalance and the extent to which Cayman's rising debt threatens Government's fiscal sustainability.

III. Government Debt and Sustainability

The Question of Sustainability

The U.K. Foreign and Commonwealth Office (FCO) has expressed reservations about the ability of the Cayman Islands Government to sustain its debt. The extract below from the Minister's letter on this subject indicates that the principal concern is sustainability in the medium term:

On the basis of the information so far available, I remain concerned that your budget forecasts are highly optimistic, on both the expenditure and revenue sides. Your budget plans leave little room for maneuver in the event of unforeseen contingencies, and your public finances may not be sustainable in the medium term.¹⁶

Sustainability in fiscal policy was recently defined in a World Bank report as follows:

Can the current course of Fiscal policy be sustained, without exploding debt? Or will the government have to sharply increase taxes, decrease spending, have recourse to monetization, or even repudiation?¹⁷

As the World Bank report points out, the generally-accepted key indicator used for both monitoring debt and comparing debt levels among countries is debt as a percent of GDP -- or the portion of a year it would take to pay off the debt if the country's entire output were devoted to that purpose.¹⁸ It should be noted that few countries use the same methodology in calculating this statistic. Even so, it is useful as a broad guide to relative fiscal positions and sustainability based on past experience. The figures for countries with which the Caymans might be compared, as well as figures for the Caymans, are shown in Table 3-1:¹⁹

¹⁶ Source: Letter from FCO Minister Chris Bryant to Hon. McKeeva Bush, October 8, 2009.

¹⁷ Eduardo Ley, "Fiscal and External Sustainability," World Bank, February 28, 2009.

¹⁸ The Debt-to-GDP ratio (or debt as a percent of GDP) statistic is something of a hybrid inasmuch as debt is a stock and GDP is a flow.

¹⁹ Sources: Figures are for total government debt except where indicated and are taken from U.K. Pre-Budget Report, December 2009 (U.K.); World Economic Outlook, October 2009 (U.S. and Euro Area); IMF Report, 2009 (St Lucia); and the Cayman Islands Government's recent bond Offering Memorandum, November 19, 2009 (Cayman Islands).

Table 3-1: Historic Debt-to-GDP Ratios -- 2004 to 2009 (2009 estimated)

<i>Debt (Net) as a Percent of GDP:</i>	2004	2005	2006	2007	2008	2009
<i>Trading Partners:</i>						
U.S.	42.4	42.7	41.8	42.3	47.9	58.2
U.K.	32.1	34.0	35.3	36.0	36.5	44.0
Euro Area	60.3	60.5	67.8	65.7	69.2	80.0
<i>Caribbean Countries:</i>						
St Lucia	-	-	43.2	43.9	37.9	40.6
Bahamas	-	-	39.7	41.0	42.5	49.6
<i>Competitor Countries:</i>						
Malta	-	-	74.5	73.0	75.6	79.8
<i>Cayman Islands:</i>						
Core Government	8.1	7.3	7.3	7.0	10.8	16.5
Total Government	12.4	11.0	12.0	11.8	16.0	22.2

Since 1977, the U.K. has incurred a Debt-to-GDP ratio ranging from a low of 34.4 percent in 1991 to a high of 52.6 percent in 1997.²⁰

Until the current global economic downturn, the advanced economies regarded a 40 percent ratio as a level of debt which is more than comfortably sustainable, and it was the U.K. government's official target. Because of Germany's higher growth history and because some member states had higher debt ratios to begin with, the European Union adopted a 60 percent standard, as set out in the section of the Maastricht Treaty known as the Stability and Growth Pact.

The precise amount of "what is a sustainable level of debt" has always been a matter of debate. For some people the involvement of complex mathematical calculations is considered necessary, while for others sustainability is a matter of judgment around medium- to long-term planning. Nevertheless, the less developed countries and small island states have been encouraged to maintain debt levels

²⁰ Sources: Table A10 published by HM Treasury, found on Debt Management Office website.

significantly below those of the advanced economies, in order that they can manage their debt on a sustainable basis.²¹

The numbers in Table 3-1 indicate that Cayman debt ratios are well below those of both advanced economies and also below those of less developed Caribbean economies. Nevertheless, one of the concerns of the U.K. government is that the Cayman economy is heavily dependent on the financial sector. Because of that sector's historic volatility and possible future structural changes, the FCO has taken the view that Cayman Government cannot afford to rely so much on that sector for revenues in the future.

In order to take account of the FCO's viewpoint, we have also considered what would be the Cayman Debt-to-GDP ratios without the financial services sector. In Table 3-2, we exclude 55 percent from Caymans' GDP -- which is the amount estimated by Oxford Economics in a recent report to be the contribution of the financial services sector.²² It should be noted that the 55 percent figure is an estimate of the "direct, indirect and induced impacts." Consequently, a partial or complete closure of the financial services sector might well have a significantly greater or lesser impact on GDP than forecast because of unanticipated effects elsewhere in the local economy. Nevertheless, we believe this calculation has merit.

The current debt of the Government, both "core" and "total", with and without the inclusion of the local financial services industry is set out in Table 3-2.²³ In this table we have not netted out the core Government cash balance, since that is reserved to meet 90 days of essential operating expenses, as required by the Principles of Responsible Financial Management (see next section and Chapter VI).

²¹ See, for example, International Monetary Fund, "Assessing Sustainability," May 28, 2002.

²² Oxford Economics, "Benefits of the Financial Services Industry to the Cayman Islands," February 2009.

²³ Source: Recent bond Offering Memorandum, with conversion from US\$ to CI\$ using 1.2:1.

**Table 3-2: Cayman Islands Government's Debt-to-GDP Ratios
With and Without the Financial Services Industry**

	2004	2005	2006	2007	2008	2009
GDP - Including Financial Services						
Nominal GDP (in millions CI\$)	1,983	2,266	2,389	2,570	2,704	2,550
GDP Growth in Real Terms (%)	0.90	6.50	4.60	4.40	1.10	-5.80
Debt:						
Core Government (in millions CI\$)	160.8	164.6	173.8	180.7	291.8	421.3
Total Government (in millions CI\$)	246.3	250.3	285.4	303.9	432.3	565.2
Debt as a Percent of GDP:						
Core Government	8.11	7.26	7.27	7.03	10.79	16.52
Total Government	12.42	11.04	11.95	11.83	15.99	22.16
GDP - Excluding Financial Services						
Nominal GDP (in millions CI\$)	892	1,020	1,075	1,156	1,217	1,148
GDP growth in Real Terms (%)	0.90	6.50	4.60	4.40	1.10	-5.80
Debt:						
Core Government (in millions CI\$)	160.8	164.6	173.8	180.7	291.8	421.3
Total Government (in millions CI\$)	246.3	250.3	285.4	303.9	432.3	565.2
Debt as a Percent of GDP:						
Core Government	18.02	16.14	16.16	15.62	23.98	36.71
Total Government	27.59	24.54	26.54	26.28	35.52	49.25

Three significant observations may be gleaned from Table 3-2. First, there can be no doubt about the importance of the local financial services industry to the Cayman economy and the dependency of the Government on the industry for its ability to service its debts. Second, partial or complete closure of the local financial services industry

would demonstrate Government's inability to deal with its debt. And third, in the five years from 2004 to 2009, Core Government debt increased rapidly, from CI\$160.8 million to CI\$421.3 million (161 percent), and Total Government debt also increased, from CI\$246.3 million to CI\$565.2 million (129 percent).

We have no hesitation in saying that such a rate of increase in Government debt cannot be sustained into the future.

Managing the Debt

In assessing the manageability of the Government's debt we take the view that Government should not only comply with the Islands' Principles of Responsible Financial Management (discussed below and in Chapter VI) but should also seek to be comfortably within sustainability standards adopted by advanced economies such as the U.K.

The two relevant Principles incorporated into Cayman law that apply directly to government debt are:

- (1) Net debt should be no more than 80 percent of core government revenue; and
- (2) Debt servicing costs should be no more than 10 percent of core government revenue.

These Principles, when followed, have served the Caymans well. A further self-imposed policy has been that "we will only borrow for capital investments."²⁴ In certain years the Government's annual surplus, before interest charges, when combined with depreciation, was close to the net investment in core Government assets. The outcome of the Principles and policies amounted to a strong fiscal policy and considerable private-sector growth.

As will be seen in the remainder of this chapter, local priorities in the last few years changed with respect to major capital expenditures, with smaller surpluses being targeted. The Cayman Islands leadership was not alone in pursuing expansionist policies – most countries around the world did likewise, and many broke sound financial rules.

The most recent projections of debt for the U.K. are shown in Table 3-3.²⁵

²⁴ Strategic Policy Statement, FY2010/2011.

²⁵ Source: U.K. Pre-Budget Report, delivered to Parliament December 8, 2009, p. 168.

Table 3-3: Projections of Debt for the U.K.

Percent of GDP	2008/9	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
	Outturn	Estimate	Projections				
<i>Sustainability:</i>							
Public Sector Debt	44.0	55.6	65.4	71.7	75.4	77.1	77.7
Core Debt	42.8	50.8	57.1	60.7	62.4	63.0	63.0
Net Worth	22.4	17.3	6.6	0.4	-3.6	-6.2	-7.2
Treaty Debt Ratio	55.5	72.9	82.1	88.0	90.9	91.6	91.2

The equivalent numbers for the Caymans are:²⁶

Table 3-4: Projections of Debt for the Cayman Islands

	2008/9	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
	Outturn	Estimate	Projections				
GDP \$m	2,550	2,463	2,503	2,603	2,686		
Percent Change in GDP		-3.4	1.6	4.0	3.2		
<i>Percent of GDP:</i>							
Core Government (incl FSI)		20.1	20.2	18.8	17.5	n/a	n/a
Core Government (excl FSI)		44.7	44.8	41.8	38.9	n/a	n/a
Net Worth \$m		569	591	627	668		

²⁶ Source: Commission calculations based on Government's recent bond Offering Memorandum, Strategic Policy Statements, and Annual Estimates. Note that GDP numbers are for calendar years, whereas debt numbers are for fiscal years and are not netted with cash balances, as previously explained.

Table 3-4 shows that if those forecasts for the Government are adhered to, then the Government will achieve a greater correction to its debt ratio than the U.K. government anticipates for its own finances.

The data laid out in the Strategic Policy Statement for FY2010/2011 appears to us to be “challenging” in seeking to achieve an operating surplus, and we believe that some consideration of downside possibilities should be addressed. In the Government's recent Offering Memorandum a number of risks to the Government's future financial performance are set out. We have not carried out an update of the forecasts, but we perceive that further investigation is required of the following risks in addition to those set out in the Offering Memorandum (pp. 8-12):

- Revenues from the recent duty, license, and other fee increases could fall short of expectation because of the difficulty of making accurate predictions in current circumstances, particularly for income derived from work permits; in light of delays in implementing certain revenues assumed in the Strategic Policy Statement; and the fact that preliminary revenue figures for FY 2009/2010 are falling short of forecasts.²⁷
- Costs that are due to be restrained and even reduced are relatively fixed by employment-related contracts, and both staff and non-staff savings may not be sustainable throughout the three-year forecast period;
- There is a mismatch between sources of revenue and expenditure:
 - Revenue growth from duties on imports is dependent on continued growth in the economy, and increases in prices and volumes from license fee increases historically are constrained by financial services market pricing. Consequently, neither of the main sources of revenue increases are automatically in line with nominal (or even real) GDP;
 - Expenditure is growing faster than even nominal GDP, with staff salary costs seemingly tied to at least inflation plus 2 percent in addition to extraordinary increases in civil service healthcare and pension costs (see Chapter IV);
 - Annual operating expenses grew by 41 percent from FY2005/2006 to FY2008/2009. According to the Strategic Policy Statement of

²⁷ Note by the Minister of Finance, Tourism & Development, "Financial Report for Period 1st July 2009 - 31st December 2009."

FY2010/2011: “This rate of increase is not sustainable.” But we have not seen any evidence of substantial reductions in Government expenditure. For example, the forecasts show spending in:

- FY2009/2010 just 1.1 percent below FY2008/2009;
 - FY2010/2011 only 0.1 percent below FY2009/2010; and
 - FY2011/2012 only 1.7 percent below FY2010/2011;
- Asset sales are not in an advanced stage, and the sales timetable may not be met. The planned privatization of the new Government building might actually result in a net revenue decrease over the forecast period;
 - Existing assets require a rate of replacement that may be in excess of that planned. The Strategic Policy Statement says the Government will abide by the Principles of Responsible Financial Management and only borrow for capital expenditure, which is limited to a forecast of \$61 million over the next three years. However, the asset base has risen from \$615 million at the end of June 2006 to a forecast \$1,170 million at the end of June 2010 – an increase of \$565 million in five years (of which \$300 million was incurred on Land and Buildings [L&B]). This is an annual rate of \$113 million. Even if replacement and further acquisitions are deferred, expenditure on non-L&B assets is likely to be at least \$40 million per annum on a normal sustainable basis, or \$120 million over the three-year forecast period;
 - Investment capital required in Statutory Authorities and State Owned Enterprises historically has averaged \$10 million each year. The Government has made investments and/or had to cover losses even in benign economic times.

Debt Service and Interest Rates

The Government's public-sector debt is predominantly denominated in U.S. dollars, with a small amount denominated in Euros. There is no domestic debt (that is, denominated in Cayman Islands dollars). As of October 31, 2009, the amounts of external debt outstanding were as follows:²⁸

²⁸ Source: Government's recent bond Offering Memorandum of November 19, 2009 (amounts outstanding) and Government's Invitation to Tender for the provision of long-term financing dated October 17, 2008 and awarded February 9, 2009 (interest rates and maturities).

**Table 3-5: External Debt as of October 31, 2009
(excludes guaranteed debt of public corporations)**

Obligation and Primary Lender	Amount Outstanding (US\$mill)	Interest Rate*	Maturity*
Cayman Islands Government 2003 Notes	92.9	5.3%	April 2018
First Caribbean International Bank (Cayman) Ltd	211.1	Various tranches, rates 4.85%-5.58% or 3 mth LIBOR +45-50 basis points	Various from June 2014 to June 2023
Royal Bank of Canada, Scotiabank & Trust (Cayman) Ltd and HSBC Bank (Cayman) Limited	185.9	One month LIBOR + 100 to 200 basis points**	Bridge facility expires 31/12/09
HSBC Bank (USA) National Association	75.0		Bridge facility expires 23/4/10
Caribbean Development Bank	3.2		
European Development FD	<u>2.2</u>		
Total Debt	<u>570.3</u>		

* Preliminary figures.

* **Dependent upon Cayman's maintaining a rating from Moody's of at least A3 or equivalent.

In November 2009, Government issued U.S. dollar-denominated 10-year notes in an amount of \$312 million at a fixed interest rate of 5.95 percent -- which was generally considered by commentators to be reasonably satisfactory relative to other sovereign and national government credits. The proceeds of this issue were to be used (1) to repay a substantial amount of the outstanding FY2008/2009 bridge facility provided by Royal Bank of Canada, Scotiabank & Trust (Cayman) Ltd., and HSBC Bank (Cayman) Limited, (2) to repay in full the outstanding amounts drawn under the FY2009/2010 bridge facility provided by HSBC Bank (USA) National Association, and (3) to finance ongoing capital projects with any remaining.

Cayman was first assigned a foreign currency debt rating in 1997 by Moody's, and its current rating is Aa3 (stable) which is regarded as investment grade. In its assessments, Moodys places considerable reliance on Cayman's high GDP per capita. This statistic is heavily dependent on the continued success of Cayman as an international financial center. Any long-term diminution of the financial services industry's contribution to Cayman's GDP would undoubtedly result in a significant downgrade to below investment grade level. This would lead to increased debt service

costs, and given the present forecast levels would result in a breaching of the Principles of Responsible Financial Management.

Debt service payments in recent years have been rising with increasing debt levels, as shown in Table 3-6.²⁹

Table 3-6: Annual Debt Service Payments, Core Government

Year to 30 June	Principal Repayments	Interest Payments	Total Debt Service
	(CI\$000)	(CI\$000)	(CI\$000)
2007	15,095	8,849	23,944
2008	17,931	10,124	28,055
2009	24,421	14,150	38,571

Projected annual service payments on the existing debt are shown in the Table 3-7, excluding the FY2008/2009 and FY2009/2010 bridging facilities, which were to be retired upon receipt of the proceeds from the new bond issue.³⁰

²⁹ Source: Conversion of U.S. dollar amounts set out in recent bond Offering Memorandum.

³⁰ Source: Commission calculations based on data provided by Cayman Treasury.

Table 3-7: Annual Service Payments on Existing Debt, Core Government

Year to 30 June	Principal Repayments	Interest Payments + Fees	Total Debt Service
	(CI\$000)	(CI\$000)	(CI\$000)
2010*	25,491	35,048	60,539
2011	25,491	40,292	65,783
2012	25,176	39,140	64,316
2013	25,071	37,886	62,957
2014	25,071	36,664	61,735
2015	24,303	35,499	59,802
2016	19,304	34,497	53,801
2017	18,770	33,537	52,307
2018	18,770	32,626	51,397
2019	10,022	31,836	41,858
2020	260,391	13,614	274,005
2021	8,476	943	9,419
2022	8,474	597	9,070
2023	7,846	214	8,060
2024	1,614	14	1,629
2025	166	9	175
Beyond	<u>802</u>	<u>7</u>	<u>809</u>
Total	<u>505,240</u>	<u>372,423</u>	<u>877,663</u>

* Includes fees on the issue of notes in November 2009, estimated at US\$2m.

** Notes issued in 2009 have a bullet repayment in November 2019, no sinking fund assumed.

The Principles of Responsible Financial Management (PRFM) limit debt service costs to 10 percent of core Government revenues, with debt service costs defined to include total interest payments, other debt servicing expenses (including arrangement fees and sinking fund expenses), and principal or amortized debt repayments. Table 3-

8 shows the recent historic and projected percentages based upon the information contained in Table 3-7:

Table 3-8: Debt Service Ratios on Existing Debt, Core Government

Year to 30 June	Total Debt Service Costs	Government Operating Revenues	Debt Service as a Percent of Operating Revenue	Margin (over) / under PRFM
	(CI\$000)	(CI\$000)		(CI\$000)
2007	23,944	517,112	4.6	27,767
2008	28,055	528,211	5.3	24,766
2009	38,571	487,411	7.9	10,170
2010P	60,539	562,218	10.8	(4,317)
2011P	65,783	580,000	11.3	(7,783)
2012P	64,316	585,000	11.0	(5,816)
2013P	62,957	590,000	10.7	(3,957)

These debt service numbers for fiscal FY2010/2011 to FY2012/2013 are higher than those projected in the recent Strategic Policy Statement for FY2010/2011, which are reproduced in Table 3-9.³¹

Table 3-9: Projections from Strategic Policy Statement for FY2010/2011

Year to 30 June	Government Operating Revenues	Debt Service as a Percent of Operating Revenue	Margin of 'Safety'	Margin (over) / under PFRM
	(CI\$m)		(Percent)	(CI\$000)
2011	580	9.10	0.90	5,220
2012	585	9.82	0.18	1,053
2013	590	9.89	0.11	649

³¹ Source: Strategic Policy Statement for FY2010/2011.

The difference in the two sets of numbers arises from the recent increase in core Government debt levels. The Strategic Policy Statement was produced before issuance of the notes in November 2009 and as far as we can determine the debt levels assumed in the Strategic Policy Statement were lower than the actual levels at the end of November 2009. The net proceeds of the US\$312 million bond issue were to be used to retire a maximum of US\$261million of bridge finance facilities, with the balance available for capital projects.

The debt service cost figures, as they appear to be following the issuance of the notes in November 2009, indicate that Cayman will breach the 10 percent Principle in fiscal year FY2009/2010, and this breach will continue into subsequent years, even assuming there is no further debt taken on by Government. This also assumes no sinking fund payments for the notes issued in November 2009.

The impact of variations in interest rates also needs to be considered in relation to the Principle of maintaining debt service costs at or below 10 percent of core Government revenues. Much of the older debt as well as the recently-issued notes carry fixed interest rates. However, a substantial tranche of the First Caribbean International Bank (Cayman) Limited debt is at a margin over three-month LIBOR. Moreover, new debt taken on to replace existing debt repayments is susceptible to variations in market interest rates. In view of the new very steep U.S. yield curve, it is entirely likely that interest costs on new or variable-rate Government debt will rise significantly in the future, thus putting further pressure on the debt service ratio Principle.

Sustainability Standard for Public Debt

The “gold standard” for smaller countries' public debt is considered to be New Zealand, which is followed by a number of British Commonwealth countries. Our attention has been drawn to a comparison with New Zealand in part because the Government's finance department studied that country's financial management reforms, and the Principles of Responsible Financial Management incorporated into Cayman law are based on their experience and systems. It is also useful to consider New Zealand in the context of debt sustainability.

At the start of the 1990s, New Zealand was considered to have unsustainable debt, with a Debt-to-GDP ratio of 50 percent, which was still rising. A change of government, together with the appointment of a determined finance minister, resulted in substantial improvements which have been widely followed and adopted:

New Zealand ran large deficits through most of the 1980s, with the ratio of debt-to-GDP increasing from 14% in 1980 to 50% in 1992. Beginning in the early 1990s, fiscal restraint policies helped to eliminate the deficit.

Government expenditures were reduced from 43% of GDP in 1990 to 32% of GDP in 1996. In 1994, New Zealand reported its first surplus in more than a decade. As a result, New Zealand was able to decrease its debt-to-GDP ratio to 14% by 2000, a 36-percentage point decrease from 1992.³²

The benefits of this past fiscal prudence are apparent. In the just-published Budget Report of December 15, 2009, New Zealand is shown to have held gross debt down to 24.1 percent in 2009, with a projected rise to 36.0 percent in 2014. The same figures for net debt are 9.5 percent and 29.0 percent respectively. It should be noted that New Zealand has a larger public sector, with an extensive welfare support program and that it has not been immune from global financial problems. Nevertheless, New Zealand's debt ratio is well below many policy norms in large countries, and Cayman is only just below it. Without the benefit of its financial services industry, Cayman would have a debt ratio considerably higher than New Zealand's.

Based on the above analysis of compliance with the Principles of Responsible Financial Management and the Debt-to-GDP ratio comparisons, we would have concluded that Cayman's debt position is satisfactory albeit somewhat stretched towards the maximum that is prudent. However, the situation we have found in relation to contingent liabilities and which we consider further in the next chapter is sufficiently serious as to require urgent consideration of further steps.

³² Source: Study by Alberta Finance Department, 2005.

IV. Contingent and Unfunded Liabilities

This chapter addresses the Cayman Island Government's contingent and unfunded liabilities -- specifically its defined-benefit pension program, its defined-contribution pension program, its program of healthcare benefits, and its guarantee of loans.

Defined-Benefit Pension Program

The following background information is found in the Government's November 2009 bond Offering Memorandum:

The Public Service Pensions Board (the “Pensions Board”) was established on January 1, 1992 as an independent statutory entity with fiduciary responsibilities for managing the public sector pension plans.

The Public Service Pension Plan is the largest of the plans administered by the Pensions Board. Under this plan, public service employees that joined the public service prior to April 14, 1999, were offered a “defined benefit” pension scheme, while employees that joined the public service after that date were enrolled on a “defined contribution” scheme. This change restricted the unfunded pension liability of the Pensions Board. The Pensions Board also operates two further pension plans: the Parliamentary Pensions Plan and the Judiciary Pensions Plan.

Contributions to the pension plans are based on actuarial assessments carried out every three years. The last such valuation for funding purposes was carried out as of January 1, 2008. As of that date, the defined benefit obligations under the three pension plans had a combined unfunded pension liability of approximately US\$248.4 million. **As of July 1, 2009, the unfunded pension liability has been estimated to be US\$324.8 million.** This amount represents the difference between the current value of defined benefit pension obligations accrued to public servants and the current value of assets in the three pension plans. Although this amount is substantial, the liability is not payable in full at once. **The 2009/2010 budget included provision for US\$26.4 million relating to the current costs of providing benefits under these pension plans for fiscal year 2009/2010.** The “past service pension liability” contributions, representing the amortization of the unfunded past service liability, are made by us to the pension fund in addition to the ongoing pension expenditures.³³

³³ Emphasis added.

The implications of the information contained in this statement to the Government's budget process and debt sustainability are considerable. A liability has been incurred which future generations will increasingly have to meet in cash terms for which an inadequate provision has been made. The cash outflow increases as more civil servants retire. The liability has increased significantly in recent years alongside greater expectations of longevity which have impacted all defined-benefit pension programs.

Following our request, we were supplied with the Pensions Board's own actuary's report relating to 2005. The current position with regard to the three pension plans is a matter which should be of considerable concern to Government, the Judiciary members, Ministers, and Members of the Legislative Assembly, past, present, and even future civil servants, as well as some other beneficiaries. We believe that this matter must be addressed urgently because (1) the last Annual Report was published in 2004, but audited financial statements have been deleted from the online file, and there is no publicly-available information on investment performance. Moreover, assumptions about interest earnings may be out of date. In short, we find a surprising lack of transparency in the Government's pension programs.

The last actuarial valuation was carried out in July 2006, and its purpose was to establish the liabilities as of the first of January 2005. To our knowledge, there has been no subsequent actuarial valuation. The 2006 valuation projected annual benefit payments (cash) of just under \$20 million in 2010 (8 percent of payroll), rising each year to \$50 million in 2020 (20 percent of payroll), \$80 million in 2030 (30 percent of payroll), and peaking at \$100 million in 2040 (43 percent of payroll).³⁴

These amounts are based on current commitments made to pensioners which will have to be met by (1) Government's contributions, or (2) employee contributions, or (3) partly by the investment income on the assets currently held in the fund. According to the actuarial report, the assets applicable to the defined-benefit program were some \$112 million on January 1, 2005, and the return on those assets is understood to be insufficient to meet even the current annual payments, let alone the increasing liability.

It is important to stress here that the retirees to date have been relatively small in number, and consequently the cost in the Government's budget has been increasing relatively slowly so far. This will change as more defined-benefit pensioners retire.

As no current audited financial statements are available, we are unable to comment on the ability to meet future payments other than to say that it appears that

³⁴ Source: Watson Wyatt Worldwide, "Actuarial Valuation of Public Service Pensions as of 1 January 2005," Cayman Islands Pension Board, July 10, 2006.

the Government will have to provide substantial and increasing funds if it wishes to support past pension expectations. This increasing annual cost would have an impact on limiting the Government's capacity to spend money on new policy initiatives, and/or it would require a continuing substantial increase in revenues from new taxes, duties, fees, or asset sales.³⁵

Defined-Contribution Pension Program

In order to rescue what was rapidly becoming an unsustainable situation, the Government closed the defined-benefit programs to new members. Instead, new civil servants are only eligible to participate in a defined-contribution plan.

The theoretical position under defined-contribution programs is that assets and liabilities are matched and that pensions are dependent solely on amounts paid in and investment performance. Consequently, the risk of securing a fund that meets retirement objectives is not with the employer (that is, the Government) but is with the employee. The only liability of the employer should be to maintain the agreed-upon contribution rate.

Many such programs, however, include guaranteed annuity rates, and we have not been able to verify if any such “guarantees” (as to management or pension amount) have been included in the Cayman program. If any have been, then the liabilities could be significant. It is important to budgeting in the Caymans that if there are any contingent liabilities for its defined contribution plans they should be determined.

Unfunded Healthcare Benefits

The following background information is contained in the Government's recent bond Offering Memorandum:

Public servants, including their spouses and dependent children, are entitled to free medical and dental care during their public service and after retirement, subject to certain eligibility requirements.

A valuation of the post-retirement healthcare benefits as of July 1, 2004, was completed which **valued the accrued liability for post-retirement healthcare benefits for retired and current public servants and eligible individuals no longer employed by the public service to be approximately US\$798 million.**

³⁵ We note that no reference is made to the defined-benefit liability in the annual Strategic Policy Statements, and the information provided in the Annual Estimates is limited to a single number without any detailed explanation.

Although, as of the date of this offering memorandum, no valuation for this accrued liability is available as of a more recent date, **we believe that such liability is likely to have increased significantly since that date.** While this amount is substantial, the liability is not payable in full at once.

.....2009/2010 budget included provision for US\$17.2 million relating to the current costs of providing benefits to retired public servants.

In addition, we are currently reviewing ways in which this accrued liability may be limited or reduced, such as by capping the amount payable to any one individual or by limiting eligibility under these plans.³⁶

The total liability of the Cayman Islands healthcare program is thus nearly twice the Government's current public debt. Like the pension liabilities described above, the annual cash payments have been a relatively small proportion of the annual budget, but are now increasing rapidly as more eligible people retire.

Some relevant features of the healthcare program are:

- There is no fund, and payments are met by Government on a pay-as-you-go-basis;
- In all treatments (other than some dentistry and eye-care services), 100 percent of the cost is paid by Government; and
- Eligibility extends beyond core Government employees, and we understand that the extent of the "healthcare promise" and eligibility may not be fully documented.

The Government's healthcare program appears to be based on providing "free-of-charge," healthcare benefits according to patient need similar to the U.K. National Health Service, while incurring costs of services that are considerably higher. According to the Cayman Islands National Insurance Company's annual report and financial statements, a number of "off island treatments" costing over \$700,000 each, have been authorized and paid for. Because of the costs of using Miami (or similar) treatment centers and the need to provide air transport in some cases, the burden of the healthcare promise to civil servants is considerable and increasing at the historic rate of 5 percent per annum -- which is higher than the Caymans' historic rate of increase in GDP.³⁷

³⁶ Emphasis added.

³⁷ Source: "Actuarial Valuation for IAS19 Reporting and Operating Balance Accounting as at July 1, 2004," Report to Cayman Islands Government, September 15, 2009.

From the documentation we have seen it appears that the current program, if not changed so as to reduce its costs and discourage excessive use, will rapidly become unaffordable. Even with changes in the program, it is likely that additional spending cuts, revenue increases, or increases in employee contributions will be required to sustain it.

Loan Guarantees

The Government guarantees the debt of six Statutory Authorities and State Owned Enterprises in addition to the core Government debt. As shown in Table 4-1, these guarantees amounted to US\$170.7 million (CI\$136.6 million) as of the end of September 2009. In addition, Statutory Authorities and Government Government Owned Enterprises had a further US\$38.9 million (CI\$32.4 million) of non-guaranteed debt as of the same point in time. Although this debt is not guaranteed, it is inconceivable that the Government would fail to meet the obligations if called upon to do so. As of October 31, 2009, there was a further US\$5.4 million of loans outstanding to the Tourism Attraction Board, the University College of the Cayman Islands and the Cayman Islands Airports Authority -- all of which are serviced by Government but where the debt service costs are recovered from the entities.³⁸

³⁸ Source: Debt figures are taken from the Government's recent bond Offering Memorandum (November 19, 2009) and have not been reconciled with figures in the FY2009/2010 budget documents which appear to show substantially higher levels of debt in the Statutory Authorities and Government companies.

Table 4-1: Non-Core Government Debt as of September 30, 2009

Statutory Authority / Government Company	Amount Outstanding		Net Worth at 30/6/09**	Net Surplus / Loss	
	(US\$mill)	(CI\$mill)	(CI\$mill)	2008/9 (CI\$mill)	2007/8 (CI\$mill)
Government Guaranteed Debt:					
Cayman Turtle Farm (1983) Limited	55.6	46.3	(7.4)	(10.8)	(14.8)
Cayman Islands Development Bank	36.7	30.6	7.6	0.3	0.3
Cayman Airways Limited	46.4	38.7	(42.7)	(2.6)	(4.5)
Cayman Islands Airport Authority	0.9	0.8	53.7	4.5	3.8
Port Authority	13.8	11.5	40.2	0.4	0.5
National Housing Development Trust	<u>17.3</u>	<u>14.4</u>	(0.8)	(1.2)	(0.9)
Total Guaranteed Debt	170.7	142.3			
Non-Guaranteed Debt	38.9	32.4			
Serviced Loans*	<u>5.4</u>	<u>4.5</u>			
Total	<u>215.0</u>	<u>179.2</u>			

* As of October 31 2009.

** Forecast as of March 2009.

Table 4-1 identifies the three consistently loss-making entities on which the total debt guaranteed by Government was CI\$95.4 million as of September 30, 2009. The Government is trapped among (1) closure when the debts are called in, (2) continuing to fund the loss-making enterprises, or (3) paying the debt to new owners pursuant to privatization. If the debts were called, this would impact the Government's net expenditure up to the extent of the guaranteed debt of CI\$95.4 (subject to any assets which might be available for sale) and would adversely impact any forecast surplus. Furthermore, the action of paying off the debt would require additional borrowing, which would then impact the total debt of Government, its Debt-to-GDP ratio, its compliance with the six Principles of Responsible Financial Management, and potentially its credit rating.

V. Personnel Costs and Their Impact on Fiscal Sustainability

During the last decade there have been frequent mentions of concern in the Legislative Assembly about the growth and size of the civil service. In this particular extract from 2005, reference is made to both Government and Opposition Members of the Legislative Assembly having expressed concern that “the cost of the civil service was strangling the financial resources of this country:”

Mr. Rolston M. Anglin: “I have a great concern for where we are going to be in 5-10 years. I know I share that concern with all Members of this House. In fact, I can remember a few years ago, in 2002 if I recall correctly, the now Minister of Education spoke about the fact that the civil service and the cost of the civil service was strangling the financial resources of this country. We may not agree on a lot of things, but we agree on that. I am concerned because I hear that same Minister—now that he is a Minister—telling this House every day about a new person he needs. I hope he will find people already in the civil service to fill these posts. I hope it will not be new positions and new bodies coming in. And I know he has that concern as well.”³⁹

From our research, which is set out below, the concerns expressed in the quotation above about “strangling the financial resources of this country” appear to have been justified.

Targets for the Level of Government Employment

The World Bank maintains a website devoted to reforming the public sector and improving the control and management of government employment. The metrics which are given to guide governments are as follows⁴⁰:

- Public sector wage bill as a percent of GDP:

This ratio can vary between 5 percent and 25 percent, with many countries around the 10 percent mark. Developing countries tend to have smaller governments relative to GDP and consequently a lower ratio.

- Number of government employees as a percent of total population:

Reformers are interested not only in the size of the wage bill but also in

³⁹ Source: Hansard, Official Report, November 9, 2005.

⁴⁰ Ismail Radwan of PriceWaterhouseCoopers, report prepared for World Bank, 2002.

the number of public servants. Governments acting as an "employer of last resort" have often taken on large numbers of public servants in the lowest grades on meager wages. These are often the most unproductive government employees, but the extent of such a problem will not be immediately apparent by examining the wage bill alone.

- Number of government employees as a percent of total employment:

This metric is similar to the preceding one, but it corrects for developing countries that have a relatively high proportion of children in the population, leading to a relatively low public servant to population ratio.

- Public sector wage bill as a percent of total public sector spending:

In order to deliver quality public services, governments will need to spend money on goods and services as well as wages and salaries. As a rule of thumb, when this ratio rises over 25 percent governments risk reducing their effectiveness by squeezing non-wage expenditures such as goods and services, maintenance, and capital expenditure. In practice, this means that hospitals will lack medicines, schools will go without textbooks, et cetera.

- Average government wages compared to per-capita GDP:

In order to recruit quality staff, encourage productivity, and avoid corruption, governments in developing countries must pay their employees at least a living wage. This ratio provides an important indicator of whether government employees are under- or over-paid in comparison to the prevailing standard of living. A larger numbers of dependants, the relative scarcity of trained labor, and low standards of living imply that this ratio will tend to be larger in developing than developed countries. However, this does not mean that government employees are over-paid.

- Recruitment growth rate:

When recruitment of civil servants grows faster than GDP, revenue, or population, it is clear that either financial stability (growing deficits) or future performance (through reduced wages or reduced non-wage expenditure) will be jeopardised.

This last metric is particularly apposite for the Caymans and identifies how the present situation posing a risk to fiscal sustainability has come about. In the remainder of this chapter we consider five of the World Bank's six metrics and relate them to the situation faced by the Cayman Islands Government.

The Significance and Size of Personnel Costs

Table 5-1 shows the significance of personnel costs in relation to revenues and operating expenses.

Table 5-1: Revenues and Expenses – Core Government Only^{41 42}

CI\$000 - Years to 30 June	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10 Budget
Total Operating Revenue	370,029	462,907	517,111	528,211	487,411	562,218
Total Operating Expenses	335,304	376,341	446,731	503,792	537,367	531,864
Personnel Costs	162,821	172,402	206,937	215,624	252,265	243,964
Annual Increases:						
<i>Increase in Revenues (Percent)</i>		25.10	11.71	2.15	-7.72	15.35
<i>Increase in Expenditure (Percent)</i>		12.24	18.70	12.77	6.66	-1.02
<i>Increase in Personnel Costs (Percent)</i>		5.88	20.03	4.20	16.99	-3.29
<i>Personnel as Percent of Revenues</i>	44.00	37.24	40.02	40.82	51.76	43.39
<i>Personnel as a Percent of Expenditures</i>	48.56	45.81	46.32	42.80	46.94	45.87

⁴¹ Core Government excludes State Owned Enterprises.

⁴² (1) 2004/5 - Estimated Actual from 2004/5 Pre Election Update; (2) 2005/6 - Estimated Actual from 2007/8 Annual Plan & Estimates; (3) 2006/7 - Estimated Actual from 2008/9 Annual Plan & Estimates; (4) 2007/8 - Estimated Actual from 2009/10 Annual Plan & Estimates; (5) 2008/9 - Estimated Actual from 2009/10 Annual Plan & Estimates; and (6) 2009/10 - Forecast from 2009/10 Annual Plan & Estimates.

Relative to 2004/5:

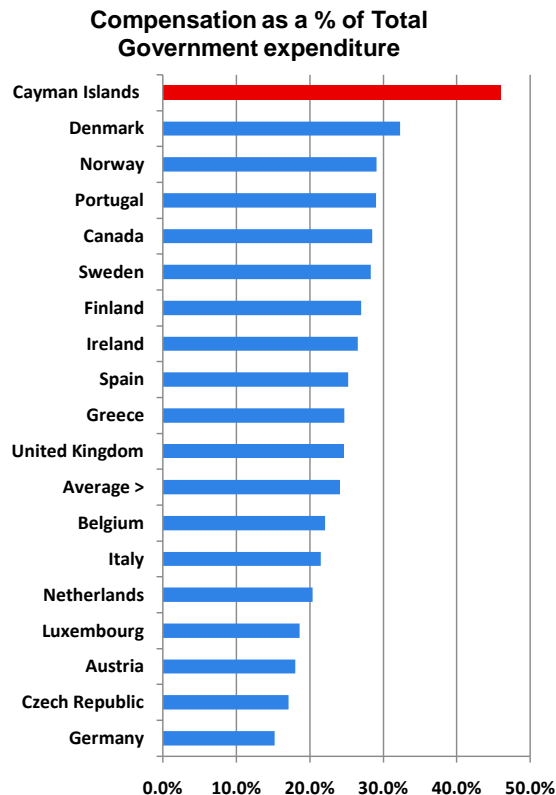
Revenue (Percent)	25.10	39.75	42.75	31.72	51.94
Operating Expenses (Percent)	12.24	33.23	50.25	60.26	58.62
Personnel Costs (Percent)	5.88	27.09	32.43	54.93	49.84

Table 5-1 also shows that in FY2008/2009 personnel costs exceeded half of Government revenues -- an extraordinarily high figure when compared to other countries.

Figure 5-1 shows employee compensation as a percent of total Government expenditure for Cayman and for 17 OECD countries. The data is based on a publication sponsored by the European Commission⁴³ and is based on the OECD Classifications of the functions of government and, in order to make comparisons more accurate, excludes the defense sector. For Cayman, the data is the five-year average from FY2004/2005 to FY2009/2010 of 46 percent, and for other countries the data is for FY2005, the most recent year available.

⁴³ Source: Table of OECD data included in Public Administration Employment in 17 OECD Nations, 1995 to 2005.

Figure 5-1: Compensation as a Percent of Total Government Expenditure



One reason why Cayman appears at the top of Figure 5-1 is that other governments have extensive welfare programs and public health services. However, Cayman does operate limited programs in those areas and so, while some difference is to be expected, a portion of the difference may be because of a policy of over-employment. It has been reported that other Caribbean countries over-employ, and a recent web article about Bermuda stated that compensation of its government employees amounted to the relatively high level of 40 percent of government expenditure. Nevertheless that is still 6 percent less than that of Cayman.⁴⁴

Increase in Numbers of Civil Servants

In the last seven years the number of civil servants employed by core Government increased from 3,097 on July 1, 2003, to a record high of 3,904 on June

⁴⁴ Calculated from data in website article entitled, "Bermuda Government: Bermuda's Largest Employer, Spender and Revenue Earner" <http://www.bermuda-online.org/economy.htm>.

30, 2008 – an increase of 807, or 26 percent.⁴⁵ This increase exceeded the estimated growth in Cayman's GDP. Since 2008, the number of core Government civil servants has fallen to 3,682 as of January 1, 2010.⁴⁶

During our interviews on Grand Cayman we asked about the number of core Government employees and also the total employed by Government -- the latter statistic including employees in all the Statutory Authorities and State Owned Enterprises. We found that the total figures were not readily available and note that, subsequent to our visit, it has been reported that there are 2,355 people employed by Statutory Authorities and State Owned Enterprises. This makes a total Government workforce of 6,037, which is 15.5 percent of the estimated labor force of 39,000.⁴⁷

Civil Servants in the Labor Market

In Figure 5-2, we compare total Government employment for the Cayman Islands and similar data for other developed countries. It should be noted that there are difficulties in collating such data, and it is not always strictly comparable between nations because of differences in collection methods. The data in Figure 5-2 is for the most recent year available, 2005, and was produced by the OECD's Public Employment and Management Working Party on January 28, 2008.⁴⁸ Nevertheless the data show that despite not having many of the responsibilities held by larger nations, such as assessing and collecting direct taxes, extensive welfare systems and, national defense, the level of Government employment is on a par with or exceeds that of many of them.

This has two implications for labor costs faced by private business in the Cayman Islands:

- (1) The private business sector that is paying the revenues that fund Government may be paying for more Government employees than is required.
- (2) The private business sector is likely to be competing with Government for labor in a limited market and to an extent not experienced in many other competitor countries.

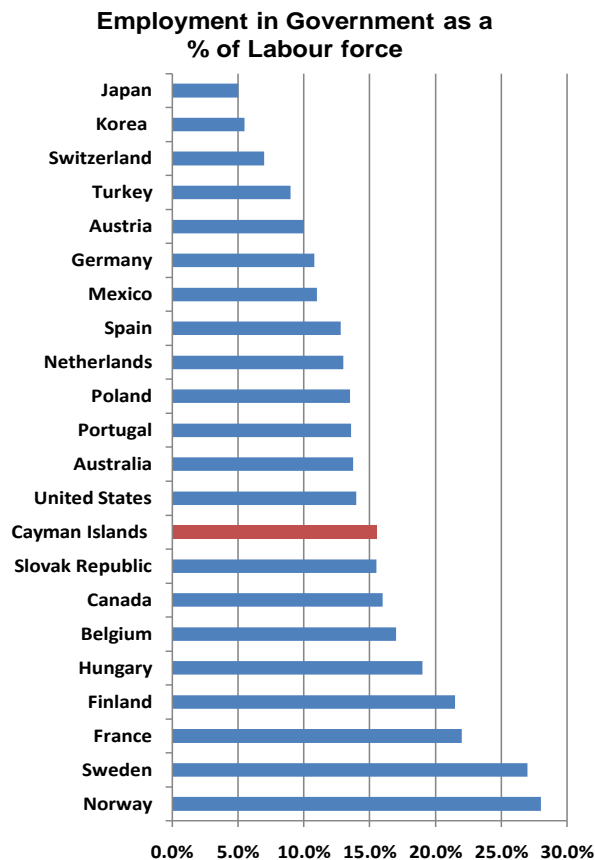
⁴⁵ Payroll data supplied by Cayman Islands Government.

⁴⁶ Article on Cay Compass website, January 26, 2010.

⁴⁷ Source: Cayman Islands Government bond Offering Memorandum, November 19, 2009.

⁴⁸ OECD, Employment in Government in the Perspective of the Production Costs of Goods and Services in the Public Domain, January 28, 2008.

Figure 5-2: Number of Government Employees as Percent of Labor Force



A further implication of Figure 5-2 is that Government might be carrying out more functions than are necessary or a similar number of functions but less efficiently. Some of the difference may be accounted for by a lack of competitive contracting out when appropriate and/or a lack of privatization compared with other countries.

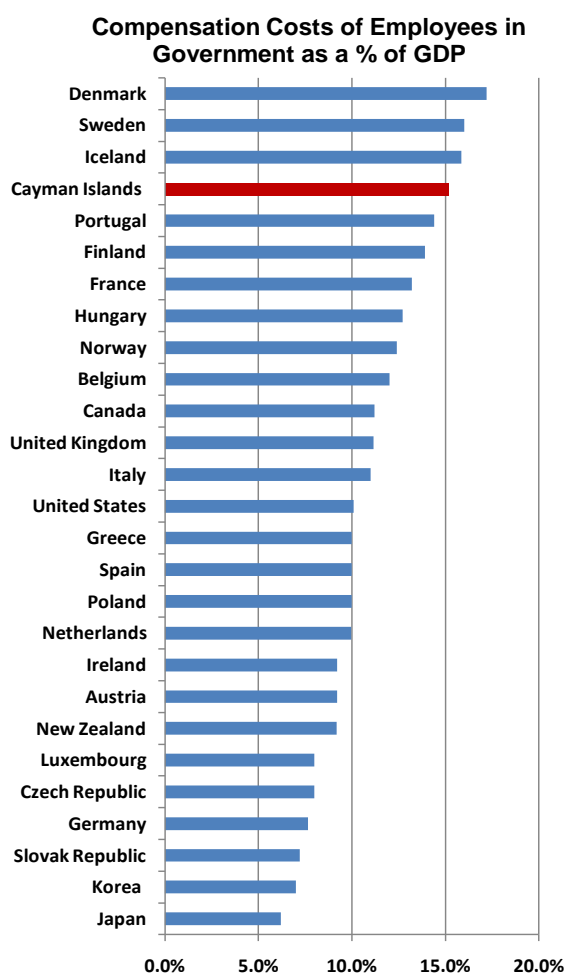
We have noted that in recent years a small number of additional functions have been added to those of Government as a result of the U.K.'s international treaty obligations. However, new responsibilities in human rights, data protection, and freedom of information have been adopted widely, and we see no reason why Cayman's Government should be less efficient in adding those functions than in other countries.

Comparison of Personnel Costs to GDP

Both the International Monetary Fund and the OECD publish comparative data on personnel costs. The data must be used with caution because of small differences in definition. Nevertheless, the data is valid for broad comparisons, because the percentages represent the size of government in an economy, and that does not change significantly from year to year in most developed countries.

Figure 5-3 is based on the same OECD data set as Figure 5-2, other than the data for the Cayman Islands which is based on GDP and other estimates. In the report from which the data has been extracted a warning is given that different accounting treatment of pensions' liabilities does occur between countries. However, it should be noted that the Cayman Government's personnel costs will appear lower in Figure 5-3 than would otherwise be the case because no provision is made for unfunded health care costs and only limited provision has been made for unfunded pension liabilities.

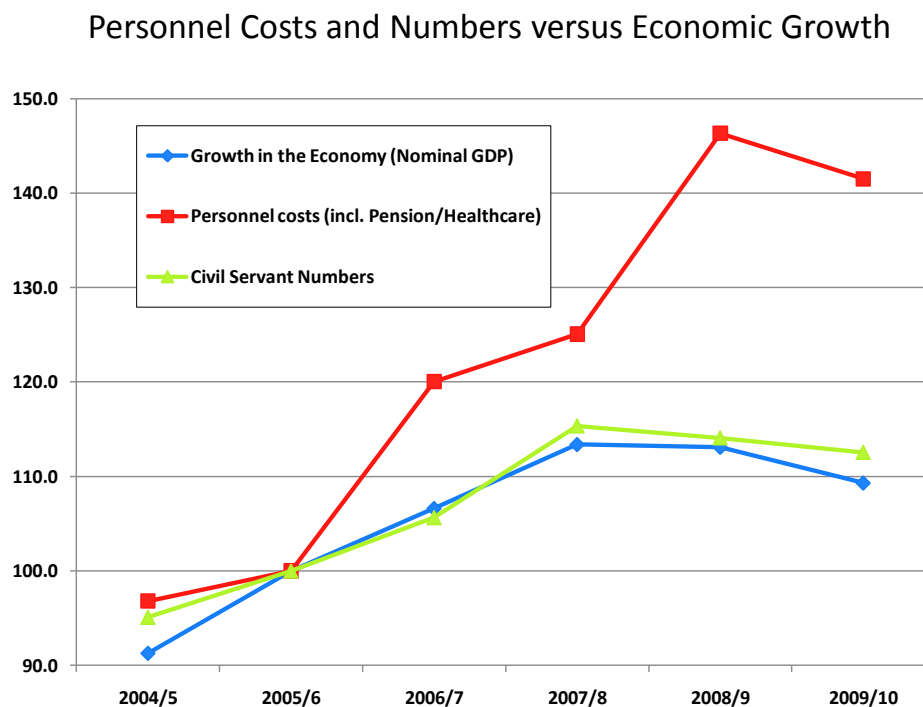
Figure 5-3: Compensation of Government Employees as a Percent of GDP



Although the data in Figure 5-3 was taken from OECD figures for 2005 versus Cayman figures for FY2009/2010, the relative positions are unlikely to have changed materially since that time. This is confirmed by the 2007 International Monetary Fund's publication, "Government Finance Statistics Yearbook 2008" which has similar numbers to those supplied by the OECD for countries other than Cayman.

The position of Cayman near the top of Figure 5-3 results from the growth in personnel costs over the last five years, which exceeded GDP in growth rate by a considerable margin. This increase relative to GDP is demonstrated in Figure 5-4, which shows growth in the economy, Government personnel costs (including pensions and healthcare), and the number of civil servants, using FY2005/2006 as the starting point for the index, as that was the last year Government was in overall fiscal balance.

Figure 5-4: Personnel Costs and Numbers vs. Economic Growth



Financial Impact of the Increase in Personnel Costs

According to the bond Offering Memorandum, the last time Government had a positive overall fiscal balance was FY2005/2006. At that time total personnel costs (including pension and healthcare annual charges but not their full accruals) amounted to 11.90 percent of GDP for total Government (including Statutory Authorities and State Owned Enterprises) and 7.42 percent of GDP for core Government.

Thus, FY2005/2006 was a significant point in Cayman's history of fiscal sustainability – it was the last time that Government could fully meet its debts when they fell due without recourse to substantial borrowing. The act of borrowing by Government is one of high political sensitivity because it diminishes Cayman's ability to manage its own affairs, as new borrowing frequently requires approval of the U.K. government.

Since FY2005/2006, matters impacting fiscal sustainability have worsened considerably. As shown in Table 5-2, the single most significant cause of the worsening financial position has been the rapid rise in personnel costs.

Table 5-2: Total and Core Government Personnel Costs as a Percent of GDP and Amount of Additional Debt Created Because Payroll Costs Increased Faster than Growth in GDP

CI\$m - Years	2004/5	2005/6	2006/7	2007/8	2008/9	2009/10
1- Total Government						
Nominal GDP	2,119.9	2,322.6	2,476.2	2,633.5	2,626.7	2,538.7
Number of Employees						6,037
Personnel Costs ⁴⁹						
Salaries & Wages	219.4	234.1	271.3	300.6	299.3	328.7
Employer/Government Pension Expense	12.0	10.6	10.0	13.6	16.0	14.0
Other Personnel Costs	17.7	10.0	18.5	10.3	36.0	39.3
Movement in Leave Provision Expense	0.3	0.0	0.0	1.0	2.1	1.0
Movement in Unfunded Liability	10.0	21.7	17.6	18.1	14.5	2.1
	259.4	276.3	317.4	343.6	367.9	385.0
Personnel Costs as a Percent of GDP	12.24	11.90	12.82	13.05	14.01	15.17
Affordable payroll target based on 2005/6 Percent of GDP			294.6	313.3	312.5	302.0
Excess payroll costs over affordable pay			22.8	30.3	55.4	83.0
Cumulative excess cost			22.8	53.1	108.5	191.5
Reduction required to bring Personnel Costs back to 2005/6 Percent of GDP						83.0
Reduction required as a Percent of 2009/10 Budget						21.6

⁴⁹ (1) 2004/5 - Estimated Actual from 2004/5 Pre Election Update; (2) 2005/6 - Estimated Actual from 2007/8 Annual Plan & Estimates; (3) 2006/7 - Estimated Actual from 2008/9 Annual Plan & Estimates; (4) 2007/8 - Estimated Actual from 2009/10 Annual Plan & Estimates; (5) 2008/9 - Estimated Actual from 2009/10 Annual Plan & Estimates; and (6) 2009/10 - Forecast from 2009/10 Annual Plan & Estimates.

Table 5-2 Continued

2 - Core Government

CI\$m - Years	2004/5	2005/6	2006/7	2007/8	2008/9	2009/10 Budget
Nominal GDP ⁵⁰	2,119.9	2,322.6	2,476.2	2,633.5	2,626.7	2,538.7
Number of Employees	3,169	3,332	3,520	3,843	3,801	3,682
Personnel Costs ⁵¹						
Salaries & Wages	139.3	141.0	168.3	182.3	195.5	196.5
Employer/Government Pension Expense	8.4	7.0	8.3	9.8	11.0	11.0
Other Personnel Costs	9.1	14.5	12.0	10.3	29.6	33.7
Movement in Leave Provision Expense	0.1	0.0	0.0	0.0	2.1	0.9
Movement in Unfunded Liability	10.0	10.0	18.4	13.2	14.0	1.9
	166.9	172.4	206.9	215.6	252.3	244.0
<i>Personnel Costs as a Percent of GDP</i>	<i>7.87</i>	<i>7.42</i>	<i>8.36</i>	<i>8.19</i>	<i>9.60</i>	<i>9.61</i>
Affordable Payroll Target Based on 2005/6 Percent of GDP			183.8	195.5	195.0	188.4
Excess Payroll Costs over Affordable Pay			23.1	20.1	57.3	55.5
Cumulative Excess Cost			23.1	43.3	100.6	156.1
Reduction Required to Bring Personnel Costs Back to 2005/6 Percent of GDP						55.5
Reduction Required as a Percent of 2009/10 Budget						22.8
Employee Average Cost (incl. Benefits) CI\$	52,670	51,741	58,789	56,108	66,368	66,259

Savings in Personnel Costs Resulting from Budget Tightening in FY2009/2010

Currently, Government has imposed a hiring freeze in order to secure savings on personnel costs. There has also been a small reduction in the number of employees -- from 3,801 on January 1, 2009, to 3,756 on January 1, 2010. Nevertheless, about half

⁵⁰ Bond Offering Memorandum.

⁵¹ *Ibid.*, fn. 12.

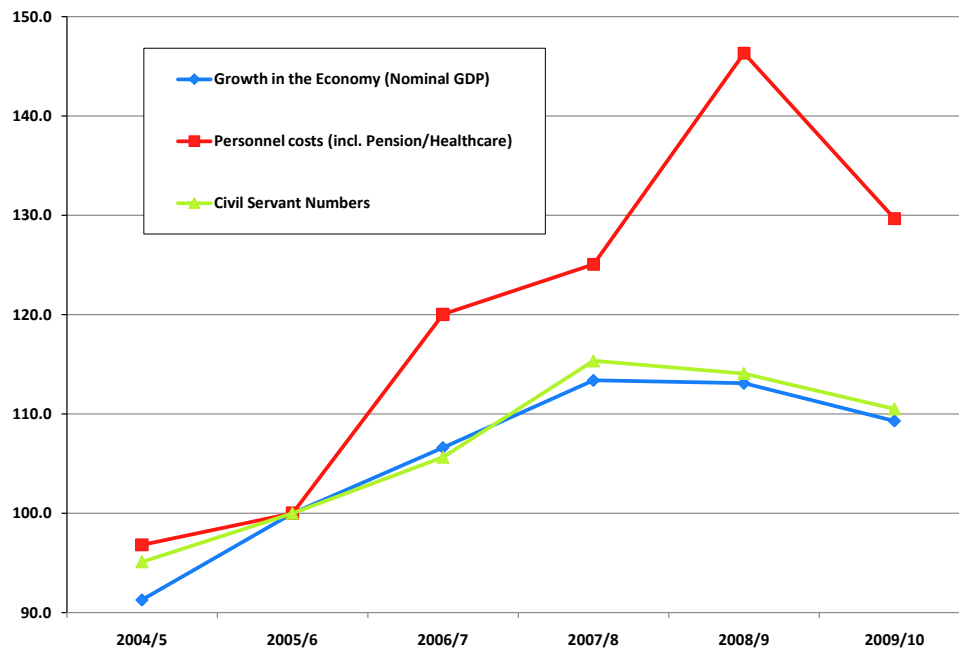
of the saving claimed is from a reduction in the “Movement in Unfunded Liability,” which underfunds the pension liability. Only about half the savings are “cash” payroll costs. Table 5-3 shows the impact of these measures, assuming that the savings for the six months to December 31, 2009 are continued until at least the end of the fiscal year at June 30, 2010.

Table 5-3: Personnel Costs for FY2009/2010 -- Budget vs. Actual

	2008/9	2009/10	2009/10
	Actual	Budget	Current
Personnel costs			
Salaries & Wages	195.5	196.5	182.6
Employer/	11.0	11.0	10.1
Pension Expense			
Other Personnel Costs	29.6	33.7	30.1
Movement in Leave Provision Expense	2.1	0.9	0.8
Movement in Unfunded Liability	14.0	1.9	0.0
	252.3	244.0	223.5
<i>Percent of GDP</i>	9.60	9.61	8.81

Figure 5-5 shows that the current freeze has had only a modest impact on the level of personnel costs and must be regarded as a short-term respite from a trend that exceeds economic growth and which seems to be well established.

Figure 5-5: Personnel Costs and Numbers vs. Economic Growth



Implications of Personnel Costs Rising Faster than GDP

Growth in GDP is the usual measure of growth in the size of an economy. Figure 5-5 shows that total Government payroll costs expanded by a quarter (specifically, from 11.9 percent to 15.17 percent of GDP, as shown in Table 5-2) in just four years. This rate of expansion cannot continue in the long term without causing irreversible damage to the private sector and making Cayman's economy uncompetitive. It would change Cayman's reputation from a "place to do business" to a "place to avoid".

In Tables 5-2 and 5-3, we set out a basis for calculating the excess payroll cost if the FY2005/2006 level of total remuneration, measured as a percent of GDP, had been achieved. Since FY2005/2006, was the last year Government's finances were in overall fiscal balance, we describe that year's percentage as the "affordable pay level." We also regard it as an affordable level for an additional reason: from the representations we have received, Government's fees, duties, and charges for services were considered by private business to be more sustainable than is the case today.

The results of this exercise indicate an estimate of the extent by which there have been excess payroll costs over the affordable levels. The calculation's result is as follows:

- Over the four years FY2005/2006 to FY2009/2010, payroll costs in excess of the affordable levels defined above have amounted to a cumulative \$191 million for total Government and \$156 million for core Government. By constraining core Government payroll costs this current year (versus the amounts budgeted), these figures are reduced by about \$20 million;
- Reducing payroll costs back to an affordable level would require a cut in salaries and benefits of CI\$83 million, or 21.6 percent, for total Government payroll and CI\$55.5 million, or 22.8 percent, for core Government. By constraining core Government payroll costs this current year, the reduction required is lessened to CI\$35 million and 15.7 percent.

These excess personnel costs must be seen in the context of Government's recently having to go to the financial markets to borrow US\$312 million. Many people commented in Cayman that the reason for the borrowing was because of the capital being spent on two new schools and the new Government office building. In fact, the cause of much of the borrowing is the need to pay the aforementioned excess personnel costs. Without the recent increase in personnel costs over and above growth in GDP, both new schools could most likely have been fully funded from normal revenues.

Clearly these figures for personnel cost increases are considerable and difficult for a junior- or middle-grade civil servant to comprehend when seeking a pay increase. Nevertheless the principle is straightforward: Government employees have received additions in pay and benefits not shared by the economy as a whole and definitely not affordable.

Of even more concern is the fact that these pay increases and excess payroll costs do not fully reflect total personnel costs. In the previous chapter we discuss the unfunded pension and healthcare liabilities. These are considerable in size and, although they are not all payable in one year, the annual cost is rising, as more and more civil servants retire and/or utilize health benefits. The build-up in personnel costs on the current model of salaries and benefits will be considerable, with cash increases projected for every year. We believe this build-up is an excessive burden for the Caymans and is unaffordable.

Many people will ask why and how has this come about?

Until recently, details of the civil service healthcare system were not widely known by the public. Our research and the recent bond Offering Memorandum revealed that estimates of this liability have increased substantially in recent years and now constitute a significant portion of total civil service costs. In Chapter IV we discuss

this liability and note that unless changes are made the program will become a substantial drain on Government resources. Current estimates of the liability (based on a 2006 report prepared by an actuary), suggest that it could be in excess of the Islands' current national debt. More recent information is very limited, and thus there is an urgent need to update the analysis and distribute it widely among the Cayman people. More importantly there is an urgent need to revise this program in order to reduce the burden faced by all Caymanians.

Pay Reviews and Increases in Remuneration

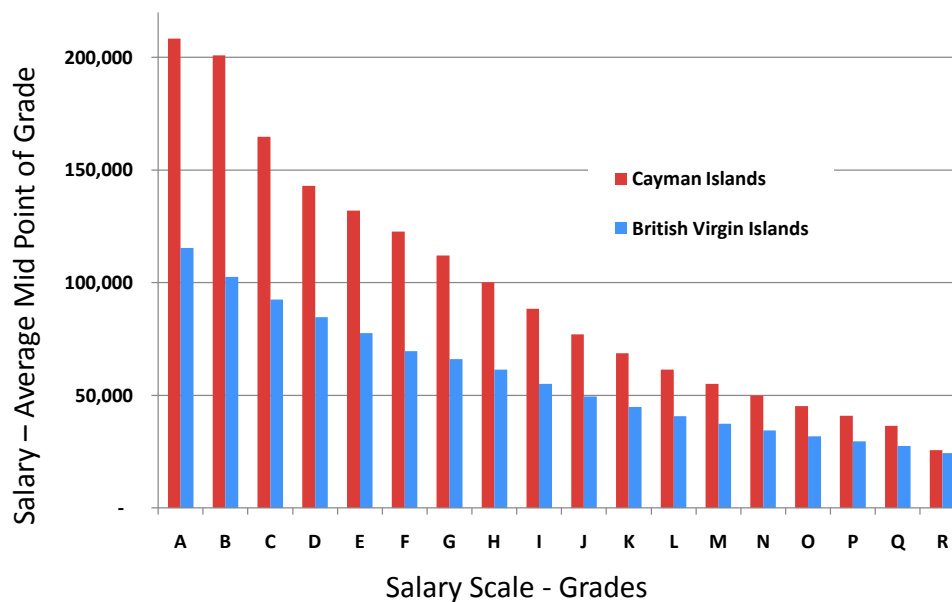
In Hansard of March 2, 2006, we noted that the senior leadership of the Cayman Islands were awarded large annual pay increases over and above the rate of economic growth or inflation. These pay increases were awarded, according to the report, in "recognition of the weightier responsibilities and prestige of the position." The increases were substantial, ranging from 10.1 percent to 18.6 percent. We note that the issue of affordability was not given as a consideration in determining the increases. In view of the lack of audited financial statements for Government, we question whether it was appropriate to make such large awards when part of the necessary financial information to determine affordability was not available.

Civil Servant Salary Scales

Because of Cayman's unique business environment and also the need occasionally to hire special expertise to fill particular skills gaps it is to be expected that Government salaries will not be far behind those of governments in the more advanced economies. Comparing salaries across different organizations and governments is difficult, of course, since definitions may differ from one government to another. Nevertheless, some trends do appear when comparisons are made. In Figure 5-6, we compare civil-servant salary scales for the Caymans and the British Virgin Islands.⁵² When considering the comparison it should be noted that we have not carried out any verification that similar grades carry precisely the same responsibilities.

⁵² Cayman Islands Human Resources Department and website of British Virgin Islands Government.

Figure 5-6: Comparison of Government Salary Scales in Cayman Islands and British Virgin Islands



We note that the average Cayman Islands salary in the top 10 grades is some 65 percent more than in the British Virgin Islands.

We also carried out some informal comparisons of senior grades in Cayman with similar grades in Ireland and the U.K. Allowing for the fact there is no income tax in Cayman, the net-of-tax salaries are superior. Indeed from our informal calculation, taking benefits into account the top five grades in Cayman all have higher net-of-tax annual incomes than the U.K. Prime Minister! We stress that these were informal comparisons, but they do appear to justify an investigation into the precise position of what appears to be an unjustified anomaly in salary scales.

Conditions of Service and Benefits

The following is extracted from a Cayman Government recruitment document:⁵³

Pension

An officer, under 60 years of age, will also become a member of the Civil Service Pension Scheme whereby 12% of salary (6% employer contribution, 6% employee contribution) will be vested in the pension fund. The employee's contribution is not deducted from salary, but is

⁵³ Cayman Islands Government recruitment information notes downloaded from the Internet.

additional to salary and paid directly into the fund. At the end of the contract the officer may withdraw the accrued balance plus interest gained as a lump sum and that sum will be payable within 30 days of the last day of service. Officers who are 60 years and over are not eligible for entry into the Pension Scheme.

Healthcare

The Government provides free medical treatment for the officer, spouse and children below the age of 19 years, who are dependent on the officer.

Dental: *Government also provides free dental conservation treatment for the officer, spouse and children below 19 years. This includes fillings and extractions and part of the cost of plates but it does not include bridges and cosmetic dentistry.*

Optical: *Free eye examination is provided once every two years plus the cost of lenses. Officers must pay for spectacle frames themselves. This provision does not apply to contact lenses though the cost of ordinary lenses may be applied to towards the cost of contact lenses.*

If the officer or a dependant has to be referred by the Chief Medical Officer to the US for treatment not available on the Island, then Government meets the cost of treatment, tests, x-rays and scans. However, the officer must meet the difference in cost between what the US hospital charges and \$200 per day which is the value of accommodation in the George Town Hospital.

These benefits are particularly generous. In practice they may be even more generous, as we understand that the average retirement age is 57, not the mandated 60. Also, pension benefits can amount to two-thirds of the ending-period salary (subject to a reduction as a result of any lump-sum payment).

While the cash cost of these benefits is reflected in Government's annual estimates (and occasionally some additional accrual has been made), their true cost on an accruals basis has not. Consequently, the figures for personnel costs which we have quoted in this report understate the total costs with respect to Government's total commitments on pensions and healthcare. (See discussion in previous chapter.) This has the unfortunate effect that salary increases have been awarded in the past without regard to their total costs. The situation is made worse by the fact that such decisions were made in the absence of audited financial statements.

Civil Service Healthcare Costs

Until recently, details of the civil service healthcare system were not widely known by the public and only limited information was known. We consider that the Cayman Islands public are entitled to this information. Our research and the recent bond Offering Memorandum revealed that costs have already increased substantially in recent years and are now having a significant impact on total civil service costs. Elsewhere in this report we discuss the future liability, which is substantial, and which, unless there are reforms, increasingly change from being a future liability and burden on the population to a current cash need. Current estimates of the liability, based on a 2006 report prepared by an actuary, suggest that it could be in excess of the Cayman Islands' national debt. There is an urgent need to review the benefits of this program and reduce the burden all Caymanians face in terms of its future liabilities.

Comparisons of Benefits

This is a comparison of healthcare contributions in Cayman with those payable in the British Virgin Islands:

Government Contribution to fund fees payable for:	Cayman Islands	British Virgin Islands
Employee	100%	50%
Spouse	100%	Nil
Dependents	100%	Nil

We have researched widely and cannot find a government with better benefit terms especially as both the pension benefit and the healthcare benefit are effectively non-contributory. These benefits may be among the best, and most expensive, in the world. We also consider that their true costs are unaffordable, as they risk making Government's debt burden unsustainable.

Other Countries' Personnel Reforms

A number of governments with similar fiscal problems have started to cut costs, with a particular focus on the number of employees and their remuneration. We set out below information on three countries with international financial centers. We have chosen to include some detail on Ireland's approach to expenditure cuts, because it is a competitor to Cayman for international financial services and operates a tax competition policy focused on attracting US corporate business. Also, Ireland's Minister of Finance set up a "Special Group on Public Service Numbers and Expenditure Programmes" ("The Special Group"), involving advisers from outside of government, which has recently reported publicly, and the following budget changes have set out:

- **Ireland**

“Public Service salaries will be reduced as follows:

5% on the first €30,000 of salary

7.5% on the next €40,000 of salary

10% on the next €55,000 of salary

This produces overall reductions in salaries ranging from 5% to just under 8% in the case of salaries up to €125,000. In place of the above reductions, salaries above this level will be adjusted in line with the recommendations of the Review Body on Higher Remuneration in the Public Sector. This will produce reductions ranging from 8% on salaries of up to €165,000, 12% on salaries up to €200,000, 15% on salaries of €200,000 or more and 20% in the case of the Taoiseach (Prime Minister).

Pension changes: Raising the minimum public service pension age to 66 years initially from 65 at present. Pensions to be based on “career average” earnings rather than final salary as currently applies. A specific “pension accrual rate” will be applied to pensionable pay so that each year public servants will earn or accrue a certain amount of pension payable on retirement. This is a fairer, more equitable and progressive system: it lowers the pensions of persons with high earnings especially in late career with less impact on the pensions of lower paid public servants with relatively “flat” career earnings such as nurses and manual workers. The Government will consider using the CPI as the basis for post-retirement increases for both existing and future pensioners. This change would reduce the actuarial cost of public service pensions. The rate of employee pension contribution remains at 6.5% but may apply to all pensionable pay....Fast accrual terms applying to the [Police], Prison Officers and Fire fighters will remain; other special terms such as added years and non-actuarially reduced retirement benefits will be generally discontinued.”⁵⁴

The Special Group called for⁵⁵ :

⁵⁴ “Summary of 2010 Budget Measures Policy Changes,” December 9, 2009; and available from <http://www.budget.gov.ie/Budgets/2010/2010.aspx>

⁵⁵ Government of Ireland, Report of the Special Group on Public Service Numbers and Expenditure Programmes,” Volume 1.

- Initial reductions of 5.5% in public service numbers;
- Further (number) reductions in the future;
- A moratorium on filling vacancies by recruitment or promotion (with very limited exceptions);
- Further payroll cost reducing schemes including early retirement, career breaks and short time working;
- Capping and progressive lowering of numbers in Ministerial Vote Groups with targets for annual reductions and redeployments;

- **Singapore**

Cuts in salaries announced in late 2008 with respect to 2009 were 19 percent for the Prime Minister, 18 percent for the Deputy PM, 16 percent for Members of Parliament and 15 percent to 25 percent for civil servants.⁵⁶ State-owned enterprise Singapore Airlines cut salaries by 10 percent (Chief Executive cut was 20 percent), but later the cut for lower-paid staff earning less than \$1,800 per month was reduced to 5 percent.⁵⁷

- **United Kingdom**

The Chancellor of the Exchequer stated in a recent interview: “The next spending review will be the toughest we have had for 20 years....to me cutting the borrowing was never negotiable. Gordon [the Prime Minister] accepts that, he knows that. Many departments will have less money in the next few years....[the cuts] are utterly totally non-negotiable”⁵⁸

Public sector faces pay cuts, says Alistair Darling, the Chancellor. Public sector workers need to follow the example of the private sector and accept wage cuts if they want to hang on to their jobs. Signalling an assault on public sector pay and bonuses, starting with the highest-paid employees, Darling said it was time for a change of culture: “What is being paid has sometimes lost the relationship it ought to have with what someone actually does. Once that happens, it’s not only unfair, it’s actually grossly inefficient,” “There’s a lot of evidence that people in the private sector have taken pay cuts and held on to their jobs.” “In some quangos,

⁵⁶ Source: Bloomberg News Service, November 25, 2008; and available at <http://www.bloomberg.com/apps/news?pid=20601110&sid=arNyY2IJP3Q>.

⁵⁷ The Straits Times, October 11, 2009.

⁵⁸ Interview with U.K. Chancellor, Rt Hon Alistair Darling MP, The Times, January 9, 2010.

local authorities and other organisations, the level of pay, especially at the top end, and bonuses have reached the stage where they don't pass what I call the next-door neighbour test. If you can't justify them to your neighbour, you've probably got it wrong," Signalling pay cuts for some posts, likely to be phased in as positions fall vacant, Darling claimed people would be willing to do the jobs for less.⁵⁹

There are many more reported examples and references to cuts in public service employee numbers and costs. In particular, individual States and municipalities in the U.S. and Local Governments in the U.K. have already begun to make considerable cuts in costs.⁶⁰ The time constraints under which our Commission has had to operate have restricted us to giving just a few of the many examples that are available.

Control and Management of the Civil Service

According to the leading book on the subject,⁶¹ the professional environment of a civil servant involves:

- Legal accountability to the courts and the law;
- Applying Human Rights and being accountable to the public;
- Freedom of information;
- Political impartiality;
- Equality of treatment; and
- Avoiding conflicts of interest especially in relation to personal financial matters.

Civil servants must work with Ministers, apply professional skills, manage public money, engage in policy processes, manage change, run meetings, plan, and measure programs⁶².

The value of a politically independent civil service cannot be overestimated. It reinforces the tradition of parliamentary democracy and upholds the system of law which maintains property and human rights. Those principles must not be compromised

⁵⁹ Interview with U.K. Chancellor, Rt Hon Alistair Darling MP, The Sunday Times, January 24, 2010.

⁶⁰ For example, the Birmingham Council has announced the reduction of 2,000.

⁶¹ Martin Stanley, How to be a Civil Servant (London: Politicos, 2000).

⁶² Source: Ibid.

or the Cayman Islands will lose key features which provide it with a unique advantage in attracting businesses and people.

A truly independent civil service is one where nepotism and corruption are avoided and honesty is recognized as worthy of praise. This ensures strong governance and independence of decision making from narrow interests. If strong and good governance is to become well grounded in a nation, however, the actions of civil servants should demonstrate that they subscribe to the ethos of putting their country's interests first and foremost.

A politically independent civil service must also appreciate that pay restraint is necessary at appropriate times. In Cayman there is a desire among many people we met for its people to be managing more of its own affairs. That degree of independence requires that borrowing be brought under control or the U.K. will be forced to intervene. Pay restraint by civil servants, whereby salaries are controlled in line with the economic growth in the economy as a whole, is fundamental to any route to self-government that might be chosen.

VI. Financial Management

The origins of the Cayman Islands' current financial management system date to a 2004 Commonwealth Secretariat Workshop which was attended by Cayman Government representatives. The Government subsequently adopted and determined to implement many of the reforms that had been developed in New Zealand.⁶³ This marked a substantial departure for the Caymans inasmuch as the New Zealand system was top-down, addressed all elements of the management system, and sought to change behaviors in order to achieve good performance. The package of reforms adopted was described as “New Public Management.”⁶⁴

In this chapter we describe the essentials of this new system and discuss some of the problems and difficulties that are apparent with its implementation.

Public Management and Finance Law

The Cayman's Public Management and Finance Law is the statute adopted by the Cayman Islands to manage its revenues and to control its expenditures. The law is common to many jurisdictions. It is impressive and almost comprehensive in terms of financial management. It, and its incorporation of six Principles of Responsible Financial Management, follow the standard developed by New Zealand, where Debt-to-GDP ratios were reduced from over 50 percent in 1992 to 25 percent in 2008.

In recent years, problems with the law have surfaced. First, the law is not being followed by various Ministries in terms of producing financial statements and other financial information on a timely basis. Second, the Legislative Assembly has not enforced its own law, according to the Auditor General and statements in the recent Bond Offering Memorandum (September 2009). And third, constitutional powers are not being utilized to ensure adherence to the law.

The six Principles contained in the law can be summarized as follows:

1. Annual debt servicing costs should not exceed 10 percent of core Government revenues;
2. Total core Government revenues should exceed total core Government expenses;

⁶³ See: “Overview of the Cayman Islands Financial Management Reform,” CARTAC Workshop Briefing, May 25, 2005.

⁶⁴ The new scheme incorporates a controversial system for tracking interagency transactions, but these are not addressed here.

3. Total core Government assets should exceed total core Government liabilities;
4. Net debt should be no more than 80 percent of core Government revenues;
5. Cash reserves should be no less than the value of estimated executive expenses for 90 days; and
6. Financial risks facing the core Government should be managed prudently to minimize risk of a related expense or liability.

In actual application, the weaknesses of the Principles are that:

- There is no specific requirement to monitor Debt-to-GDP ratios, the usual metric relied upon to determine fiscal sustainability;
- Contingent liabilities are not specifically addressed and by leaving them out entirely, Principles 1 through 4 above can be said to be met when a considerable problem is building up for the future;
- It encourages a false sense of confidence when Members of the Legislative Assembly are informed that a budget is in compliance;
- It does not address medium-term affordability issues by ensuring that a sufficient surplus is achieved at the high point of the economic cycle, so that low-point problems can be managed; and
- Compliance and control can be weakened by the inclusion of unintentional and intentional errors in the accounting for accruals and provisions at the levels of core Government, Statutory Authorities, and State Owned Enterprises.

Consequently, it is incumbent on policymakers in the Caymans to be aware of such shortcomings and to regulate Government finances accordingly.

Audit and Compliance

We have read a number of the Cayman Auditor General's reports and, in particular, the special report entitled, "The State of Financial Accountability Reporting," issued in April 2008. As with the U.K.'s National Audit Office, these reports should be of considerable value to members of the legislature. The audit reports enable Legislative Assembly Members to make important decisions based on the successes or failures of policies and to ensure that public money is spent correctly with appropriate accountability. This system of independent audit reporting to Parliament has been accepted as the best available in many countries, and the U.K. model was adopted by the European Union.

In view of the importance of independent audit and the need for Cayman, as a leading international financial center, to conduct its affairs to the highest standards, we were somewhat surprised by what we found. In particular we noted the following comments of the Auditor General:

2.12 Today, in the Cayman Islands, there is **at least \$1.5 Billion of operating expenditures that should have been accounted for that has not yet been reported to the Legislative Assembly**. To date, there has been virtually no accounting to the Legislative Assembly for these funds even though there is a legislative requirement to do so. As a result, there has been no serious scrutiny of recent governmental expenditure by the Legislative Assembly since the enactment of the PMFL in July 2004.

2.13 As a result, I believe that the **Legislative Assembly has lost effective control of the public purse**. To regain it, the Legislative Assembly will need to ensure that the financial accountability documents **required by law** are sent to them on a timely basis so that there can be a fruitful discussion between members of the Legislative Assembly and senior government officials. Without such documents that detail the revenues and expenditures of the Ministries, Portfolios, Statutory and Government Companies, no effective control can take place.⁶⁵

Financial statements complying with the new accounting guidelines were due to be presented in the Legislative Assembly by mid-December 2005. As of the date of this offering memorandum, those **internal audits had not been completed, and no statutory authorities or Government companies were in full compliance with the law. The financial statements of many Ministries and Portfolios of Government are currently three or more years late**. Even in cases where the financial statements have been timely prepared, they have not been provided to the Legislative Assembly in the required form. As a result, financial information in this offering memorandum may be subject to further review and may be materially revised.⁶⁶

This is a very serious matter. We are concerned from these comments that some parts of Government, some of its Statutory Authorities and State Owned Enterprises are being managed by people who do not have full knowledge and control of their business unit's operations and who thus are not acting in a responsible and

⁶⁵ Source: Auditor General's Report of April 2008.

⁶⁶ Source: Government's recent bond Offering Memorandum, November 19, 2009. (Emphasis added.)

accountable manner. Prompt and timely accounting and reporting is one immutable part of maintaining discipline over business activities. Many of the Statutory Authorities and State Owned Enterprises deal directly with the public and have public safety responsibilities which can endanger lives if business disciplines and controls are not maintained. Besides possible risks to public safety, unintentional error (mistake) or intentional error (fraud and corruption) can result from such control weaknesses.

The fact that such statements had to be included in the recent Offering Memorandum is unfortunate but obviously necessary and correct. It would be surprising if their inclusion had not resulted in the Government's paying a higher rate of interest on the borrowing than might otherwise have been the case.

Moreover, these statements are fully public and must be regarded as potentially beneficial to competitor financial centers. Weaknesses in financial controls also have the potential to cause problems with maintaining the Cayman Islands reputation as an honest place to do business.

Maintaining control over government and business activities is fundamental and of basic importance. We list below some key questions of control for which positive answers are appropriate in a Parliamentary democracy:

- Is each annual Audit Report published?
- Does the Audit Report on core Government confirm that action has been taken on control weaknesses and other matters disclosed in previous reports and management letters?
- Does the Audit Report on core Government include a "Value for Money" Report?
- Does the Audit Report for each Statutory Authority and State Owned Enterprise include a report on Corporate Governance?
- Does each Statutory Authority and State Owned Enterprise have Audit and Remuneration Committees?
- Does the Audit Report for each Statutory Authority and State Owned Enterprise include a report on Corporate Governance?
- Are the Financial statements considered by the Finance Committee and the Audit Reports by the Public Accounts Committee of the Legislative Assembly?

These questions need to be considered in relation to the financial reporting timetables operated by governments such as the U.K. and New Zealand. Audited financial statements are available in many cases within five months of the end of the financial year. In the case of New Zealand, its annual statement for the year ended June 30, 2009 was audited by September 30m 2009 (a three-months timetable), and its four-months interim results to October 31, 2009 were published on its website on December 4, 2009 (a five-weeks timetable).

The Budgeting Process

A well-established budgetary control mechanism is essential for any government. The current process operated by the Government of the Cayman Islands consists of five stages:

- Strategic Policy Statement prepared in October and submitted to the Legislative Assembly by December 1st, for approval within two months;
- Detailed budgeting by appointed officials;
- Review by the Governor and the Cabinet;
- Review of appropriation requests by the Legislative Assembly; and
- Documentation in the form of Annual Plan and Estimates.

Preparation of the budget for the FY2009/2010 fiscal year was delayed because the Legislative Assembly was dissolved in March 2009 prior to the elections held in May 2009. Subsequently, emergency resolutions were used to approve a four-month spending plan.

In our view, the democratic process should be able to continue without changing the timetable for achieving budgetary control. It should be possible to alter dates such that any new Government starts the financial year with a budget that was set by its predecessor but which can be altered in appropriate ways post the elections, if so required. The current rigidity in the system appears to provide a reason for not starting the post-election final year with a fully approved budget. This should not be the case.

Budgeting is fundamental to maintaining fiscal sustainability, as there is a need to maintain control over expenditures and to make timely adjustments to revenues. The budgeting process needs to be well planned and to extend well into the future in order to avoid surprises and, more importantly, to ensure that expenditure decisions are properly considered and debated. In our researches, we have found evidence that the relevant committees of the Legislative Assembly are not fully informed of the budgetary

implications of their decision making. Moreover, we find a significant lack of responsibility and accountability for spending decisions taken by the various Ministries.

Furthermore, the short time horizon used in most budgets has led to longer-term costs, such as personnel pension and healthcare liabilities, not being considered at the time initial expenditure is approved. A similar outcome has occurred in Cayman.

We consider it appropriate for the Cayman Government to update itself on the financial reporting standards and disciplines being used currently in New Zealand for the purpose of retaining Cayman's advantageous position as an investment-grade borrower and a leading international financial services center.

In our view, such a system of strong controls requires:

- Tight reporting timetables that are enforced.
- A five- year forecast 'tactical' planning horizon; and
- A 10- to 20-year 'strategy' plan to deal with issues such as the replacement, sale, and acquisition of assets; the management of contingent liabilities; keeping track of guarantees and State Owned Enterprises' trading horizons; and making necessary adjustments in revenue.

Undertaking such financial planning should be relatively easy with modern Information Technology systems and is increasingly common in local and national governments, as evidenced by "Findings from the Country Financial Accountability Assessments," published by the World Bank.

Legislative Scrutiny – Finance and Public Accounts Committees

If the democratic system is to ensure fiscal responsibility, then the relevant Committees of the Legislative Assembly need to be fully engaged in the process. We consider the following questions are relevant to determining whether there is adequate engagement by the Committees:

- Finance Committee --
 - Does it receive/debate quarterly/monthly core Government financial statements?
 - Does it receive/debate half-yearly financial statements for Statutory Authorities and State Owned Enterprises?

- Are the financial statements required by Standing Orders to be produced on a timely basis within 30/45 days of the end of the quarter?
- Are there any non-executive external expert but non-voting members?
- Public Accounts Committee --
 - Does it review the output/outcome economy, efficiency and effectiveness of each Ministerial Department at least once in the four year Legislative cycle?
 - Does it monitor financial statements and audit completion to ensure that all Departments, SOEs and Statutory authorities financial statements are signed off by auditors within 6 months of the year end?
 - Are there any non-executive external expert but non-voting members?

We believe that reforming the budget process along the lines detailed here would position policymakers in the Cayman Government to be more efficient and accountable, and may be necessary if Government is to carry out the steps needed to achieve and maintain fiscal sustainability.

VII. Methods of Raising Revenue and Controlling Spending

Previous chapters have addressed the importance of fiscal sustainability in a government's policies. Achieving and maintaining fiscal sustainability is a challenge all governments face and most meet. This chapter addresses the means the Cayman Islands Government could use to address this problem -- raising revenue through a variety of levies and asset sales (privatization) and controlling spending. Specific recommendations for how the Cayman Islands Government could meet the challenge more completely and more efficiently are contained in Chapters IX through XI.⁶⁷

Direct Taxes

Taxes on Income

Currently, there are no direct taxes on income in the Cayman Islands. If the Government wanted to institute this option, there would be several choices, including:

1. Personal income tax – The design options for this tax range from a very simple flat tax system, such as those found in jurisdictions such as Hong Kong, Jersey, Estonia, and Slovakia, to the complicated regimes with hundreds of forms such as the one found in the U.S. Policymakers would be confronted with numerous alternatives, including whether to exempt a certain amount of income, what rate(s) to apply, what deductions to offer, whether to double-tax income that is saved and invested, and whether to tax income earned in other jurisdictions. Another problem with this tax in Cayman is that the tax base is very mobile. Moreover, there are some 30,000 guest workers in Cayman, and collecting taxes due from them might be very difficult.
2. Payroll tax – A payroll tax is akin to the income tax, but generally is a flat-rate tax imposed only on labor income. Payroll taxes commonly are dedicated to finance retirement and/or healthcare programs (which is why they sometimes are known as “social insurance” levies). Moreover, payroll taxes often are at least partly “paid” by the employer, though labor economists widely agree that the burden (in the form of foregone wages) is borne by workers. The work permit system in Cayman has many of the attributes of a payroll tax but is more efficient in terms of administration, compliance, and collection.
3. Corporate income tax – This levy on business income, like the personal income tax, can be simple or complicated in its design. Key issues include the tax rate,

⁶⁷ A brief primer on fiscal finance is found at Appendix D. Included there is a discussion of which types of taxes tend to have greater or lesser adverse impact on the economy.

the treatment of investment (depreciation), and whether income from other jurisdictions is taxed (worldwide taxation rather than territorial taxation). In practice, the tax is paid out of the added value created by the company's employees who suffer a reduced income as a result. Also, the tax base is exceedingly mobile.

Income taxes would generate revenue, but they would impose high risks for the Cayman economy. Corporate income taxes, in particular, could damage the financial services sector. It would be possible to “ring fence” this industry, thus protecting it from either a personal income tax or corporate income tax, but that would undermine the goal of raising revenue and presumably would result in even higher tax rates on other sectors of the economy. In describing the imposition of additional fees on the financial services industry, the Government's recent bond Offering Memorandum noted a concern about the sensitivity of the industry to increased levies:

These policies may not produce the intended revenue while increasing the cost to investors of operating in the Cayman Islands or reducing the attractiveness of using or participating in the financial services sector such that our revenue decreases. The effects of any regulatory or tax policy changes could reduce the number of investors and entities utilizing or participating in the financial services sector, which could adversely affect our revenues.

Payroll taxes would be a less-risky option (though some jurisdictions have allowed payroll taxes to morph into de facto income taxes, with progressive rate structures and taxation of income on capital). A payroll tax certainly is capable of generating substantial revenue. But even a well-designed social insurance levy would have adverse effects on the Cayman economy, as acknowledged in the Economic and Statistics Office report on payroll tax alternatives:

As suggested in the public finance literature, compliance rates are assumed to decline with higher tax rates; thus while a 95% compliance rate is assumed for the 8% tax scenario, this is reduced to 90% for the 10% tax scenario, and to 85% for the 12% tax scenario. ... GDP in the Cayman Islands is projected to decline in 2010-2015 by 4.4% (given an 8% payroll tax) up to 6.2% (given a 10% payroll tax). ... it is projected that total employment in the Cayman Islands could fall annually by 1,600

(under the 8% tax scenario) up to 2,300 (under the 12% tax scenario) during the period 2010-2015.⁶⁸

Another issue that has to be borne in mind when considering a payroll tax in relation to the Cayman Islands is the interaction with existing work permit fees. Cayman employers already regard these as high relative to those in other jurisdictions. A payroll tax in addition to work permit fees would add to employment costs and make the Caymans less competitive in the market for skilled professionals. Furthermore, the collection of work permit fees is a binary, "yes or no," answer, depending on immigration and skill statuses. That binary simplicity of assessment and ease of administrative compliance would be lost with a payroll tax, which would require extensive administration, including investigative checks similar to the situation with an income tax.

The Cayman Islands have enjoyed substantial prosperity, in part because it is a reasonably tax-neutral platform. Adopting any form of income or payroll tax would remove much of the fiscal allure that has boosted the economy. Moreover, any form of income or payroll taxation would require the imposition of an entirely new tax system, with both high set-up costs and potentially significant and permanent compliance costs. It also is unlikely that a tax on income, regardless of form, would solve the problem of variations in revenue collections.

Taxes on Property

There is no recurring property tax in the Cayman Islands. This type of levy is not uncommon around the world, however, particularly for local governments in larger nations. These types of levies theoretically can be imposed on just about anything people own, but the tax almost always is imposed on real estate, vehicles, and boats. This section will focus on real estate-related taxes.

1. Annual property tax – Sometimes known as a community service charge, the ideal property tax is almost akin to a user fee, as governments charge an amount roughly akin to the cost of providing service. In practice, the property tax rarely resembles that ideal, since the tax tends to be progressive (assuming there is a fixed rate applied on the assessed value of the property) whereas government services tend to be proportional. Moreover, the tax often funds more than property-related services (fire and police protection, sewage systems, et cetera).
2. Transfer tax on real estate – The Cayman Government levies a fee on the sale of real property.

⁶⁸ Government's Economics and Statistics Office, "A Proposed Payroll Tax for the Cayman Islands," September 11, 2009.

A tax on the transfer of property is probably not the most efficient way to tax real estate. To generate substantial revenue, the rate must be set at a non-trivial level, yet that type of rate may lead to a lock-in effect. At the very least, it will lower the selling price of homes. It also raises horizontal equity concerns, because the tax is borne solely by buyers/sellers of property rather than all property owners.

Switching to an annual property tax raises a different set of concerns. If the housing market is volatile, it is unlikely that a property tax would ameliorate the problem of cyclical revenue flows. Also, it is not clear what effect this would have on real estate prices. By liberating property from the "lock-in effect," there might be more transactions and higher prices. On the other hand, Cayman's reputation for zero taxes on real estate would be undermined, perhaps dissuading many potential buyers. Policymakers also would need to figure out whether a property tax would be a dedicated source of revenue to finance a selected list of expenditures. Other issues include the assessment process, the appeal process, the foreclosure process, and whether to have different tax rates and/or rules for Caymanians and non-Caymanians. One key issue is the amount of money that might be raised from such a tax. When we spoke to people in Cayman about banding the tax and exempting a value level that would remove many Caymanian-owned properties, it became apparent that a 1 percent levy would not raise as much money as its proponents were advocating.

Indirect taxes

Value-Added Tax (VAT)

The Cayman Islands, like a number of island economies, has relied on import duties to raise a substantial part of its Government revenues. The attraction of duties is that they are payable on consumption and are relatively easy to structure, so essentials are lowly rated and luxury goods are more highly rated. VATs have been adopted by the majority of Governments, including some in the Caribbean, for many of the same structuring reasons as duties.

Governments like VATs because they are capable of generating substantial revenue and are somewhat self-enforcing. Economists, meanwhile, view the VAT as a relatively non-destructive way of raising revenue.

The enactment of a VAT would normally be accompanied by the repeal (or at least significant reduction) of duties, otherwise the total level of consumption taxes would become politically unacceptable, inflationary, encouraging of criminality and would require two groups of collection personnel.

VAT systems operate by requiring those businesses, which are VAT assessable, to charge output VAT at every stage that value is added to a good or service. Input

VATs are generally recoverable by businesses so that the consumer becomes the ultimate payer of a tax on the net value added. In theory, it should apply to all goods and services. Most VAT systems normally allow for zero rating of certain items including food (but not restaurant supplied food), other essentials, and frequently exempt exports and financial transactions. A further exemption is normally applied to small businesses below a certain size of sales because of the impracticality and high costs of collection.

Customs Duties

Import duties in the Caymans are a significant source of Government revenue, accounting for approximately 25 percent of the total. There is a general tariff rate of 22 percent (recently increased from 20 percent⁶⁹), as well as a set of specific levies on targeted products such as motor vehicles, fuel, alcoholic beverages, and tobacco products. The standard basis for the import duty includes insurance and shipping costs.

If policymakers wished to raise more revenue from imports, the most sensible option would be to impose higher taxes on goods with significant externalities and/or goods that have inelastic demand.⁷⁰ Obvious choices include tobacco, which satisfies both criteria (externalities because of Government-financed healthcare), and higher-value motor vehicles, because of their excessive fuel consumption. Alcohol theoretically could be in this category, but policymakers would need to be careful about the impact on tourism, which is sensitive to the factors that affect the total cost of vacations.

Sales and Excise Taxes

A potential source of new revenue, which impacts several sectors, would be to replace fixed (or specific) taxes with “ad valorem” taxes. Ad valorem taxes are percentages of the value of what is being taxed, so the government collects more money as prices rise over time. During periods of inflation, fixed taxes, such as \$X for a gallon of gasoline or \$Y for a pack of cigarettes, lead to a decline in revenue both in real terms and as a share of economic output. In the Caymans, about one-half of taxes are for pre-determined amounts, regardless of the underlying value, including products ranging from fuel levies to registration fees for financial companies. As with a VAT, collection of sales taxes at the point of sale would require a greatly expanded civil service and probably would not collect as much revenue.

⁶⁹ FY2009/2010 Budget Address.

⁷⁰ See Appendix D.

Tourism Taxes

Tourism generates a significant share of the Cayman GDP and Government revenue. The majority of tourists, about 80 percent, come from the U.S., and their spending accounts for around 20 percent of the Islands' GDP. Tax revenues directly related to tourism account for only about 5 percent of total revenue, but if indirect effects are included, the number is significantly higher.

There is no more scope for raising taxes on tourism, because there is considerable unused capacity. Part of the reason is because tourism is depressed, but part is because for some sections of the market taxes on tourism are high already.

It is not clear how much additional revenue, if any, would be generated by higher levies on the tourist trade. There are many competing Caribbean jurisdictions, not to mention states such as Florida and California, that are substitutes for travelers. Higher levies on tourists would be unlikely to result in an increased expenditure per day, and so any further increase in revenues from tourists would have a direct, negative effect on the tourism industry. There likely would be significantly fewer tourists, which would reduce revenues, whereas the sector's problems are that volumes need to increase.

Financial Center Taxes

The financial services industry is the major driving force behind the economy of the Caymans Islands, generating over one-half of economic output and almost 40 percent of direct Government revenue. The two main revenue sources are licenses/annual fees to operate and/or register financial services companies and work permits (largely, but not exclusively) for people working in the financial services industry.

Financial Services Licenses

The Cayman Islands Government imposes a wide range of fees and charges for the operation and/or registration of financial institutions such as banks, mutual funds, and insurance companies, often subsidiaries of major firms in nations such as the U.S.

Both global and local circumstances indicate that the financial services industry is not a viable source of additional Government revenue. Already, substantial fees are imposed on this industry, and it has just had to absorb higher annual company fees, registry fees, bank license fees, and mutual fund annual fees.⁷¹ Moreover, the fees that Government imposes on this industry are higher than those imposed by competing

⁷¹ FY2009/2010 Budget Address.

jurisdictions.⁷² Not surprisingly, some financial services firms are migrating to other countries, in part because of the Caymans' increasingly uncompetitive tax/fee climate.

Work Permit Fees

A substantial share of the Cayman workforce is from other jurisdictions, and these people's employers pay for the privilege of working in Cayman. Not all work permits are for people working in the financial services industry, but more than 60 percent of permits in 2008 and in the nine-month period ended September 30, 2009, were provided to administrative, professional, or skilled workers.

The issuing of work permits to a foreign worker brings considerable benefits to Cayman. These benefits are:

- Government's direct revenues – work permit fees, fees for obtaining and renewing driver's licences, paying for motor vehicle plates, import duties on goods brought into the Islands, etc.). These fees benefit Caymanians as they contribute revenues and help pay for the 75 percent of the civil servants who are Caymanian.
- Private sector direct benefits – added value from expenditures on housing, rent, supplies, services, and food purchases
- Social and educational benefits – the skills base is enhanced and widened, resulting in Caymanians having increased opportunities to acquire more and wider skills. Local training of Caymanians, without incurring unaffordable Government expenditure, is made possible by businesses importing the necessary skills. This ensures that the Cayman Islands sustains and develops its world-class professional business knowledge base.

An average work permit, according to one estimate, generates \$39,000 of indirect spin-off benefits to the private sector each year.⁷³ In addition, the employing business will earn a sufficient amount to pay the individual's salary, make some profit, and pay the work permit fee. For this benefit Government has recently increased the charges to businesses to \$10,500 for a typical professional person. The fees are higher for senior professionals and lower for less-skilled people. We were told that these new higher fees are beginning to make it very difficult for business to make sufficient added value to make a profit out of some services and that some low-margin business had

⁷² Memorandum, "Possible Fees from Financial Services," September 16, 2009.

⁷³ Paul Simon, "Cayman's Economic Growth Lost," November 10, 2009.

recently moved from Cayman to lower-cost countries in the Caribbean. We have no reason to doubt what we were told – Cayman has become a more expensive business center through increased costs of Government.

Our research has revealed that recent increases in the fees for Cayman work permits have made them extremely expensive when compared with other countries. Nevertheless, this is one area where Government might still be able to raise additional revenue. The opportunity arises because the most highly-skilled people, who are usually contributing the most to developing Caymanian peoples' skills and Cayman's professional business knowledge base, are forced to leave after seven years (or nine years) unless their term is extended. Consequently there is potential for increasing and extending certain permit fees if Government is willing to liberalize the permit regime and allow longer stays and/or a greater chance of permanent residency. Not only would this generate revenue from increased payments, there would be the indirect monetary and non-monetary benefits mentioned above.

We were also advised by both real estate developers and professional advisers that there is a current and growing interest by a number of globally successful and wealthy individuals in relocating to a place such as the Cayman Islands. This is because already there are five-star leisure and residential facilities on the Islands, and there is the possibility that some seven-star developments might be constructed if Cayman retains its attractiveness and appeal. Furthermore, the potential to transfer high-added-value business activities to Cayman would increase if the leisure and residential facilities extended to even higher market levels such as seven star. In this regard we were informed that a policy of selling residence and citizenship rights to such high net-worth individuals could be successful. A price of \$1 million to \$2 million per person or couple was quoted to us as a possibility.

Other Taxes

Energy Taxes

A broad-based tax on energy, such as a carbon tax or BTU tax, would be a selective consumption tax. It could be capable of collecting significant revenue, and could be justified on the basis of externalities and/or environmental reasons. There would be numerous implementation options, though presumably a comprehensive energy tax would replace existing duties such as gasoline and diesel fuel. As with the VAT, a further energy tax would represent a significant departure from the current system. The consequent increase in inflation would entail certain political and economic risks. It would also have a negative effect on the local Caymanian population.

Poll Taxes

The Cayman Islands could impose a residency fee, or some other “head” tax to collect a fixed amount of money from every person on the Islands. This would be a fee to finance universally-available public goods and services. It is unclear, though, whether the rate could be set at a high enough level to make it worthwhile, given the costs of implementing and collecting the fee, not to mention the equity considerations. The U.K.'s historic experience with twice having tried to impose a poll tax on its own people renders the suggestion inappropriate to contemplate in a British Overseas Territory.

Gambling Taxes

It has been suggested that the Cayman Islands Government legalize gambling (or "gaming") and tax the proceeds. In our interviews on Grand Cayman we were struck with the opposition to such an initiative as being contrary to the society's standards for moral behavior. There is also the prospect that however fashioned, a gambling industry might accentuate the crime problem to which Caymanians are presently very sensitive. Finally, the academic literature is inclusive about whether the introduction of gambling creates more benefits than costs.

Asset Sales and Privatization

Taxes and fees raise money for governments on a continual basis. Asset sales constitute one-time infusions of cash. Privatization of enterprises that lose money and require annual subsidies provide not only one-time gains, but the avoidance of subsidies and in that sense provide a stream of benefits. Transfers of simple assets such as real estate to the private sector are rather straightforward. In the case of transferring enterprises (and their associated assets), the objective is to transfer a resource from government's ownership to the private sector in exchange for cash -- and in the case of lost-making enterprises, the avoidance of annual subsidies.

Cayman Government Enterprises

The Cayman Government owns a number of enterprises, some of which operate as businesses, and some of which are business-like and capable of being privatized, either to produce cash or to eliminate annual subsidy payments. In the latter cases, Government might have to make certain concessions in the form of guaranteed payments in the event that business does not develop as intended. Even in those cases, Government would be better off financially than continuing the current regime.

Among the enterprises that would seem eligible for privatization are:

1. Cayman Airways -- At present, this enterprise is losing money and its net worth is negative. Nevertheless, private ownership could bring about efficiencies, including an end to the current policy of excessive "free passage." An alternative to stand-alone privatization would be to have the enterprise acquired by an existing air carrier.
2. Cayman Islands Airport Authority -- This enterprise is profitable, though it depends on Government payments. A private company could bring operating efficiencies and capital needed for improvements (for example, extending the runway).
3. Cayman Islands Development Bank -- This enterprise has been receiving annual subsidies, but projects a surplus this year. Government could privatize the bank's holdings and provide support for those needing capital in other ways.
4. Cayman Islands Stock Exchange -- As a profit-making institution, this enterprise is a prime candidate for privatization. In private hands it could expand the range and depth of its financial-market-related activities and generate additional revenues for Government.
5. Cayman Turtle Farm -- Because of its annual losses and its Government-guaranteed loan, this enterprise constitutes a significant threat to Government's fiscal sustainability. Government could address this problem by inviting private interest in purchasing and running either the entire enterprise or portions thereof, or purchasing the property for other uses.
6. Port Authority -- The Cayman Port Authority operates at a profit and should be considered a prime candidate for privatization.
7. Water Authority -- This enterprise provides two services: (a) potable water, and (b) disposition of sewage. The water function is fairly privatized already. The sewage function would seem ripe for stand-alone privatization.

Other Potential Opportunities

The list of privatizations and assets sales above is not meant to be exhaustive. There may be other possibilities for reducing costs by either introducing competition in the provision of services or by privatizing some Government functions. Potential opportunities should be evaluated in relation to the Civil Aviation Authority, the Health Services Authority, the National Museum, the National Cultural Foundation, the Children and Youth Service Foundation, the Electricity Regulatory Authority, the Information and Communications Technology Authority, the Maritime Authority, the National Drug Council, the National Gallery, the National Housing Development Trust, the National

Road Authority, the Sister Islands Housing Authority, the Tourism Attraction Board, and University College.

Controlling Spending

A government's deficit, which is a major determinant of its fiscal sustainability, is simply the difference between the revenue it takes in and the spending it undertakes. As explained in Chapter II, spending by the Cayman Islands Government has recently become unsustainable -- reflecting, in major part, the growth in the number of civil servants and their associated benefits (retirement and healthcare).

Macro Approaches to Spending Control

Governments in developed countries find it difficult to reduce spending -- one reason why it is so important to control spending growth in the first place. But it can be done. Various approaches have been tried, to varying degrees of success. For examples from the U.S., in an attempt to reduce spending President Jimmy Carter instituted "zero-based budgeting" on a national scale, requiring agencies to "bottom-up" their budgets each year by evaluating each program every year and weeding out those that were not performing. President Reagan helped orchestrate the Gramm-Rudman-Hollings Deficit-Reduction Act, which required across-the-board cuts in all but military and social security spending whenever estimates of the deficit exceeded legislated targets.

Limiting the growth of spending is easier than cutting spending. The typical device is some sort of "spending freeze." Proposals of this sort typically produce a good deal of confusion, for two reasons. First, there are often exclusions -- as in President Obama's excluding entitlements, military, and other security spending (an estimated 88 percent of the total) from the "freeze." Second, freezes tend to be applied to "current services" levels of spending -- that is, meeting spending commitments in current law and extrapolating discretionary spending, but not adding new programs or expanding old ones. Such "freezes" amount to spending increases, but at a slower rate than likely would have been the case otherwise. Some states have been more resourceful, instituting caps on spending, such as limiting spending to a percent of the state's GDP or limiting spending increases to the percent increase in the State's GDP.

The Cayman Islands Government has available a variety of approaches to the problem of controlling spending. It could freeze spending at current levels, for example. It could allow spending increases for only extraordinary, emergency matters, as another example. It could mandate spending cuts in specific programs. It could tie spending increases to growth in the economy or limit spending to a particular percentage of the Islands' GDP. It could mandate an across-the-board reduction in spending. It also

could spin off to the private sector some of the Statutory Authorities and State Owned Enterprises it presently subsidizes and reduce or eliminate subsidies for the rest.

Exploring the Potential for Specific Savings

New Zealand's budgetary process includes a separate requirement for Departments to identify and report on specific savings. This is an extract of the instructions which are followed:

Savings. *In Budget 2009 the Government will begin the process of carefully scrutinising public sector expenditure. Departments will be required to conduct line-by-line reviews of their programmes and expenditure during January 2009. The reviews will require Chief Executives to make their best judgement on the efficiency, effectiveness and alignment with the Government's priorities of their agencies spending. Through the reviews, Chief Executives are expected to identify:*

- *savings that can be freed up for Budget 2009;*
- *programmes that are inconsistent with the Government's priorities and should be discontinued;*
- *programmes that may be inconsistent with the Government's priorities and should be looked into;*
- *programmes and expenditure that are not efficient or effective; and*
- *areas where performance information is insufficient to make a judgement about efficiency and effectiveness, and actions agencies should take to make improvements by the next review period.*

*Departmental Chief Executives are to report on these reviews to their Minister(s) by **Thursday 5 February 2009**. Individual ministers will forward the review reports to the Minister of Finance.*

Savings identified in the line-by-line reviews are to be offered back through the Budget initiatives process, using the standard initiatives templates.⁷⁴

We note that the last three Strategic Policy Statements have not had a separate section dealing with potential savings. Such a discipline could reap substantial rewards, and we urge the Legislative Assembly to make it a formal part of the budgetary process.

⁷⁴ New Zealand Treasury, Budget Process Overview 2009. Emphasis added.

In the remaining chapters we will make specific recommendations for how Government might deal with the challenge of maintaining fiscal sustainability. It should be evident, however, that significant improvements in short-, medium-, and long-term spending controls must be part of that approach.

Cautionary Remark

Notwithstanding the current budgetary challenges, the Cayman Islands are a success story. Low taxes, the rule of law, and other sensible policies have enabled the jurisdiction to become one of the most successful economies in the world. Maintaining that status requires that the burden of government be modest, especially with regard to the way it raises revenues. A reasonable tax environment is not a sufficient condition for Cayman's prosperity, but it is a necessary one. Any move to increase the tax burden should be highly sensitive to the risks to long-run prosperity.

VIII. Conclusions

Overview

The problems that precipitated the establishment of the Commission are very simple: after a period of quite acceptable fiscal performance, spending by the Cayman Islands Government rose, both in absolute terms and as a proportion of the Islands' GDP, while revenues to the Government fell both absolutely and as a proportion of GDP. The resulting widening deficit and the failure of the Government to meet three of the six Principles specified in the governing financial law,⁷⁵ led the U.K. Foreign and Commonwealth Office to suggest decisive action to broaden and deepen the tax base and to take firm measures to control spending.⁷⁶ The establishment of this Commission and other initiatives undertaken by the Government is in response to that suggestion. The Commission's goal, based on a thorough analysis of the present situation and likely scenarios for the future, is to make recommendations about reforms in tax and spending policies that, if followed, would lead to fiscal sustainability.

The Cayman Islands are blessed with natural beauty, a highly professional workforce, and a reasonably neutral tax regime. Thus, it is logical for the Islands' economy to be based on tourism and financial services. It is also unsurprising that these two sectors -- tourism and financial services -- undergird the Government's revenues. When both sectors prosper, revenues to the Government rise; but when these sectors suffer, so do Government revenues.

The revenue base of the Cayman Islands is unusually narrow -- not only in its dependence on tourism and financial services, but the nature of the taxes it levies. It has no personal or corporate income tax, nor direct (recurring) taxes on property. Nor does it have a Value-Added Tax or a general sales tax, though its duties on imports are akin to a tax on consumption. This leaves it especially vulnerable to swings in the fortunes of the two major sectors of the economy.

Not surprisingly, both sectors at issue are very dependent on economic activity beyond the Islands. Tourism, especially, is dependent on the state of the U.S. economy. When the U.S. economy does well -- especially when disposable income is high or rising -- the Caymans' tourism industry experiences record activity. But when the U.S. economy -- and especially when the global economy -- is in a downturn, tourism on the Islands suffers.

⁷⁵ The Cayman Islands' Public Management and Finance Law -- see discussion in Chapter VI.

⁷⁶ See the quoted material from the Foreign and Commonwealth Office at the beginning of Chapter III.

The situation with respect to revenues from the financial services industry is normally a little more stable, though such revenues also are dependent on economic activity beyond the Islands. As discussed in Chapter II, the recent decline in global economic activity -- led in major part by failures in non-Caymanian financial institutions - has depressed, overall, financial services in the Islands and consequently Government revenues from this sector as well.

Government revenues driven by activity in the financial services industry are also dependent on the Caymans' relative attractiveness as a place to do business vis a vis the Islands' major competitors -- including Bermuda, Jersey, Guernsey, Ireland, Malta, the British Virgin Islands, and Singapore. Consequently, proposals relating to any additional revenue measures must be considered in the context of a highly competitive environment, where people, as well as capital, can be relocated quite easily. Bear in mind that jobs in Cayman are on the shopping lists of other governments.

Finally, Government revenues are dependent on a host of other conditions, some of which are quite easily subject to change. Hurricanes visit the Islands from time to time, causing personal injury and reducing overall wealth. Somewhat perversely, hurricanes typically increase government revenues, since the goods needed to rebuild are subject to import duties. Other scenarios can be imagined that would impact Government revenues adversely: the development of competing centers for tourism in the region, an increasingly favorable environment for business in one or more of the Islands' competitors for financial services, or even political upheaval in a neighboring locale.

Spending by the Government is more predictable in that it should normally be far more controllable. Each year the Government makes spending plans based on its policies and priorities. Unfortunately, too much emphasis is placed on the immediate year ahead and not on the medium and longer terms.

Unlike the U.S. and the U.K., the Caymans have far fewer government "entitlement", "permanent", or "automatic" spending programs such as Social Security, Medicare, and Medicaid in the U.S. or state pensions, income support, and unemployment and other welfare benefits in the U.K. Consequently, much less of the Caymans' spending program is mandated by permanent law, and thus a clear majority of spending is subject to review and appropriation each year. The only major exception is the growing liability for civil servants' pension and healthcare programs, as discussed in Chapter IV. It is troubling that the amount of the liabilities for these programs has escalated in recent years.

Of special note are the large, and growing, personnel costs borne by Government. Under realistic assumptions about cost-of-living increases as well as increases in basic salaries and the costs of benefits such as healthcare, keeping personnel costs under control in the coming years will require considerable effort.

Principal Points

Our principal conclusions may be summarized as follows:

1. The Cayman Islands are a very attractive place to live and to do business. In just a few decades the economy has risen several-fold, and the standard of living on the Islands has increased dramatically.
2. The Cayman economy is narrowly based on financial services and tourism. Consequently, any adverse developments in the world's major economies will have an adverse impact on the Cayman economy.
3. With respect to both pillars of its economy -- financial services and tourism -- the Caymans are in a very competitive world market. Competitors such as the Virgin Islands, Bermuda, Ireland, and even Canada are actively enticing financial institutions to relocate their off-shore operations to their locales. The Bahamas, the Virgin Islands, Bermuda, Miami, and California constitute for tourists attractive alternatives to Cayman.
4. Cayman's tax regime and accommodation of skilled guest workers are keys to its success in attracting and retaining financial services firms and tourists. Of particular note is Cayman's lack of direct taxation, which is particularly attractive to young professionals.
5. The Cayman Government's fiscal performance was acceptable until recently, when a combination of rapid increases in expenditures and shortfalls in revenue (owing primarily to a deteriorating world economy) gave rise to a substantial deficit, forced the Government to borrow substantial sums, and jeopardized its fiscal sustainability.
6. The Cayman Government has very large contingent and unfunded liabilities. Unfunded liabilities associated with its civil service pension and healthcare programs amount to hundreds of millions of dollars, only part of which is defrayed by current balances. Additionally, the Government guarantees nearly \$200 million in debts held by Statutory Authorities and State Owned Enterprises.
7. The Government's financial reserves are extremely limited -- only barely meeting legal minimums according to forecasts that we believe are overly optimistic.
8. Contrary to current forecasts, it is likely that the Government will complete the current fiscal year with a deficit. This will necessitate additional borrowing.

9. The Government's accounts -- for its Ministries, Statutory Authorities, and State Owned Enterprises -- are in disarray. Few have audited financials more recent than 2004.

10. It would be counterproductive for the Government to institute a system of direct taxation. Aside from the cost of establishing a completely new system of taxation and the problems of collecting the money, a major appeal differentiating the Islands as a place to do business would be lost.

11. It is equally clear that the Government's current levies on the financial services and tourism industries are very close, if not beyond, the point of maximizing revenue. That is, further increases would drive away business to such an extent that even with higher levies revenue to Government would fall.

12. The Government has substantial assets that could be monetized over a period of a few years. These include physical assets such as land, but also various enterprises, some of which require annual subsidies to support their activities.

13. Government outlays have reached a level that is not sustainable in the long run. Of particular concern is the recent increase in the number of civil servants *and* their pay and benefits. Both the defined benefit pension program and the healthcare program are extraordinarily generous by standards of other developed nations, including those with which Cayman has to compete for business in financial services and tourism.

14. The Government's budget process lacks transparency, accountability, and control. There is no single clearinghouse for expenditures, such as the Office of Management and Budget in the U.S. or Her Majesty's Treasury in the U.K. The Cayman Treasury's role in spending is limited to issuing the funds for programs that are approved by the Legislative Assembly. The current system does not enable timely control over spending, especially if committed programs overrun, leading to spending above amounts initially budgeted.

15. Grand Cayman lacks two investments that would boost tourism and almost certainly result in increased GDP and increased Government revenues: (a) extending the airport runway to accommodate larger jets and (b) providing a terminal to enable the berthing of cruise ships to offload increased numbers of passengers. Both could be addressed with private capital.

16. Government faces a liability on Grand Cayman we have not explored fully, but which appears capable of being solved with private-sector help: the removal and/or relocation of the waste processing, storage, and recycling center that is both an eyesore and an environmental hazard.

17. Government also faces infrastructure costs and liability challenges in the form of an unfinished government headquarters building and two high schools that are only partly constructed. Whatever the merits of the initial decisions to build them, failure to complete them would be even more costly in the longer run.

The Cayman Decision

The Cayman Islands faces a major decision. It can retain the relatively neutral tax regime that has contributed to its economic development, but only if it applies the discipline necessary to monetize certain assets and reduce spending. There is an immediate need for asset sales to cover the shortfall in revenues caused by the weakened world economy. But that will work only in the short run. The systemic problem must be addressed as well: Cayman's current expenditure path is simply unsustainable.

The alternative for Cayman is to continue its current spending trajectory, but only if it is willing to institute a system of direct taxation and/or a much broader and deeper tax on consumption. In order to provide anywhere near sufficient revenues, the tax - rates would need to be at international developed-country levels, and the tax base widened to include all Caymanians, including possibly some of the poorest. Even that might not work, since with its Island geography, an increase in taxes would place Cayman at a significant competitive disadvantage for financial services, tourism, and other potential enterprises, and many residents could depart the Islands. The result could well be a contraction of the economy, even less scope for Government, and a reduction in Caymans' standard of living.

The preferable course of action would seem evident, and it is the basis for the recommendations that follow.

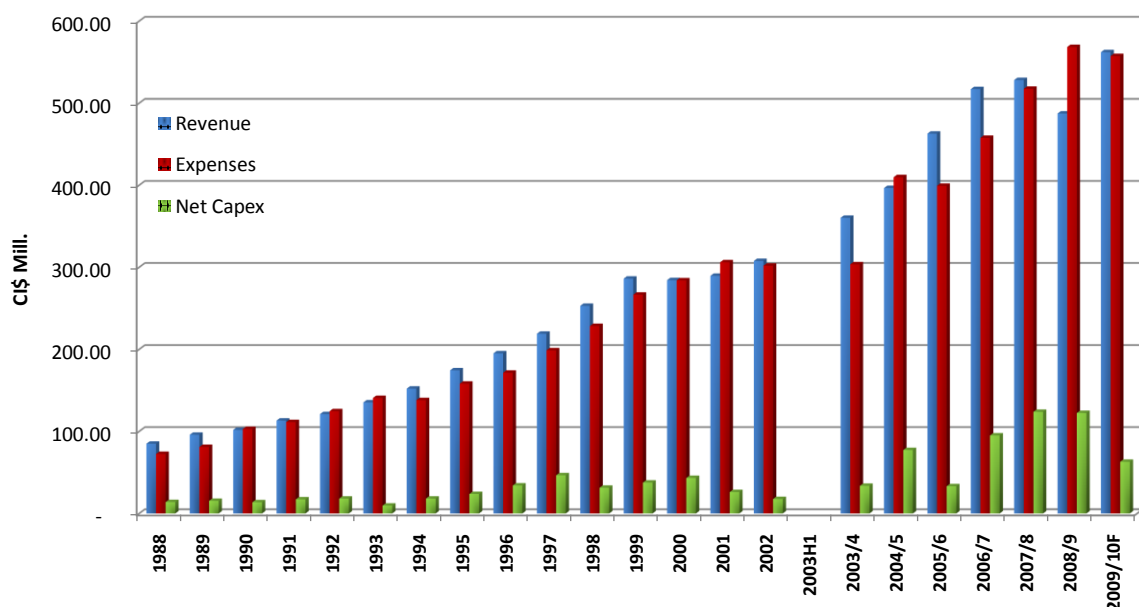
IX. Recommendations for Addressing Fiscal Sustainability

1. Do not impose direct taxation.

We are well aware of the interest of Her Majesty's Foreign and Commonwealth Office in broadening the Cayman tax base by having Government impose some form of direct taxation. We considered the pros and cons of this proposal very carefully, in the context of what would be best for the citizens of the Cayman Islands and also what would be in the interest of the U.K. government. We believe the interests of both are served by having the Cayman Islands Government address the challenge of fiscal sustainability in a way that does minimal damage to the Cayman economy. We conclude that imposing a system of direct taxation would be harmful to those interests.

We draw the conclusion that direct taxes would be harmful to the Caymans for several reasons. First, we find that the fiscal problem in the Cayman Islands is too much spending, not too little revenue. As Figure 9-1 (same information as Figure 2-3) illustrates, both revenues and spending have risen significantly in the past 20 years, and the growth of the government sector accelerated even faster in the last six years. The Government's fiscal shortfall exists because spending has grown even faster than revenue.

Figure 9-1: Spending Rising Faster than Revenue

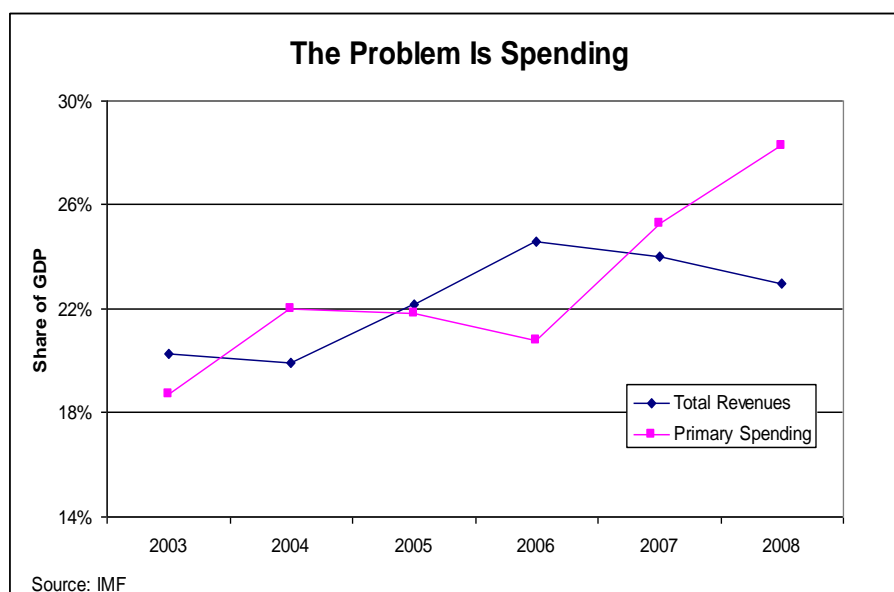


Note: Expenses include interest expense and extraordinary costs.

More specifically, the Cayman Government enjoyed a period of buoyant revenue growth and spent money as if receipts would continue their rapid climb. When the windfall of rapidly-rising revenue vanished and was replaced by a modest drop in revenue, there ensued a severe fiscal challenge. But the challenge developed only because spending grew so rapidly – and also because no plans were made (such as a contingency fund) in preparation for the inevitable recession-induced decrease in revenue.

In its 2009 Assessment of the Cayman Islands, the International Monetary Fund published some revealing numbers.⁷⁷ As Figure 8-2 illustrates, both revenues and spending climbed as a share of economic output between 2003 and 2008. But spending grew much faster, rising by about 10 percentage points of GDP over the period while revenues rose 3 percentage points. Interestingly, if the public sector had grown at the same rate as the overall economy, the Cayman Islands would be enjoying a budget operating surplus today. Instead, there is a deficit because of a substantial escalation in Government spending that began in 2006.

Figure 9-2: The Problem is Spending



Second, we are convinced that an increase in the tax burden in the Caymans would hinder the performance of its economy. We base this observation on a wealth of academic research indicating that higher tax burdens restrain economic growth. In part, this is because taxes discourage economic activity, but it is also because higher tax

⁷⁷International Monetary Fund, 'Cayman Islands: Off-Shore Financial Center Assessment Update -- Assessment of Financial Sector Supervision and Regulation,' Table 1 Selected Economic Indicators, December 2009.

burdens divert resources to the public sector, where evidence strongly indicates they are used less efficiently.

Consider the results of a few such studies.⁷⁸

- A European Commission report acknowledged: “[B]udgetary consolidation has a positive impact on output in the medium run if it takes place in the form of expenditure retrenchment rather than tax increases.”⁷⁹
- A study by the International Monetary Fund reached a similar conclusion: “This tax induced distortion in economic behavior results in a net efficiency loss to the whole economy, commonly referred to as the ‘excess burden of taxation,’ even if the government engages in exactly the same activities—and with the same degree of efficiency—as the private sector with the tax revenue so raised.”⁸⁰
- A study from the Federal Reserve Bank of Dallas noted: “[G]rowth in government stunts general economic growth. Increases in government spending or taxes lead to persistent decreases in the rate of job growth.”⁸¹
- Research from the Organization for Economic Co-operation and Development (OECD) concluded: “Taxes and government expenditures affect growth both directly and indirectly through investment. An increase of about one percentage point in the tax pressure—e.g. two-thirds of what was observed over the past decade in the OECD sample— could be associated with a direct reduction of about 0.3 per cent in output per capita. If the investment effect is taken into account, the overall reduction would be about 0.6–0.7 per cent.”⁸²
- A Federal Reserve Bank of Cleveland study reported: “A simulation in which government expenditures increased permanents from 13.7 to 22.1 percent of GNP (as they did over the past four decades) led to a long-run decline in output

⁷⁸ Also, see Appendix D and references cited therein.

⁷⁹ European Commission, Directorate-General for Economic and Financial Affairs, “Public Finances in EMU, 2003,” *European Economy*, No. 3, 2003, February 2, 2005.

⁸⁰ Vito Tanzi and Howell H. Zee, “Fiscal Policy and Long-Run Growth,” *International Monetary Fund Staff Papers*, June 1977.

⁸¹ Dong Fu, Lori L. Taylor, and Mine K. Yucel, “Fiscal Policy and Growth,” *Federal Reserve Bank of Dallas Working Paper 0301*, January 2003.

⁸² Andrea Bassanini and Stefano Scarpetta, “The Driving Forces of Economic Growth: Panel Data Evidence for the OECD Countries,” *OECD Studies* No. 33, February 2002.

of 2.1 percent. This number is a benchmark estimate of the effect on output because of permanently higher government consumption.”⁸³

- Another OECD study found: "...the increase in the average (weighted) tax rate of about 10 percentage points over the past 35 years may have reduced OECD annual growth rates by about ½ percentage point. ...one of the endogenous growth models finds that a cut in the tax-to-GDP ratio by 10 percentage points of GDP (accompanied by a deficit-neutral cut in transfers) may increase annual growth by ½ to 1 percentage points (a somewhat larger effect than that found by the “top-down” approach).”⁸⁴

This sampling of academic reports is augmented by other research that tries to determine the growth-maximizing level of government. Based on current data, scholars have concluded that to maximize economic growth the public sector should consume somewhere between 17 percent and 23 percent of GDP. A study for the Joint Economic Committee of the U.S. Congress, for instance, found, “The optimal level of federal government spending is about 17.6 percent of GDP. Beyond this point, the resources consumed by government impose more costs on the economy than benefits.”⁸⁵

By these standards, the public sector in the Cayman Islands is too large, now commanding nearly 30 percent of the Islands' GDP. Consequently, it would be unwise to increase taxes or impose new taxes, which would almost inevitably lead to a further expansion in the size of Government.

The third reason we recommend against the imposition of a system of direct taxation is evidence that such a system causes much more damage to the economy per dollar of revenue than alternative revenue systems.⁸⁶

In the academic literature, taxes that affect the work-leisure choice and the consumption-saving choice are categorized as “distortionary” taxes, meaning that they are more likely to reduce economic performance than other taxes. Personal income taxes and corporate income taxes fit that category, while consumption taxes are thought

⁸³ Charles T. Carlstrom and Jagadeesh Gokhale, "Government Consumption, Taxation, and Economic Activity," Federal Reserve Bank of Cleveland Economic Review, 3rd Quarter, 1991.

⁸⁴ Willi Leibfritz, John Thornton, and Alexandra Bibbee, "Taxation and Economic Performance," Organization for Economic Cooperation and Development, Economics Department Working Paper No. 176, 1997.

⁸⁵ Lowell Gallaway and Richard Vedder, "The Impact of the Welfare State on the American Economy," Joint Economic Committee, U.S. Congress, December 1995.

⁸⁶ Also see discussions in Chapter VIII and Appendix D.

to be more benign, and the evidence is mixed concerning payroll taxes and property taxes. The important point is that all taxes are paid out of current or past income, so any levy is going to alter the tradeoff between work and leisure. The real issue is which types of tax cause the most or least distortions.

Here is a sampling of scholarly research findings.

- From the Organization for Economic Cooperation and Development: “The results of the analysis suggest that income taxes are generally associated with lower economic growth than taxes on consumption and property. ...Corporate income taxes appear to have the most negative effect on GDP per capita. ...There is also evidence of a negative relationship between the progressivity of personal income taxes and growth.”⁸⁷
- Another OECD study notes: “Investment is shown to respond negatively to an increase in the corporate tax rate and a decrease in capital depreciation allowances through changes in the user cost of capital. ...The paper finds evidence that corporate and top personal income taxes have a negative effect on productivity.”⁸⁸
- Still another OECD study finds: “...taxes also affect the decisions of households to save, supply labor and invest in human capital, the decisions of firms to produce, create jobs, invest and innovate, as well as the choice of savings channels and assets by investors. What matters for these decisions is not only the level of taxes but also the way in which different tax instruments are designed and combined to generate revenues... The effects of tax levels and tax structures on agents’ economic behavior are likely to be reflected in overall living standards. ... A revenue neutral growth-oriented tax reform would be to shift part of the revenue base from income taxes to less distortive taxes. ...Focusing on personal income taxation, there is also evidence that flattening the tax schedule could be beneficial for GDP per capita, notably by favoring entrepreneurship. ... Taxing consumption...appears to have significantly less adverse effects on GDP than taxing income. Corporate income taxes appear to have a particularly negative impact on GDP per capita. This is consistent with the previously reviewed

⁸⁷ Jens Arnold, "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries," Organization for Economic Cooperation and Development, Economics Department Working Papers No. 643, 2008.

⁸⁸ Laura Varttia, "How Do Taxes Affect Investment and Productivity? An Industry-Level Analysis of OECD Countries," OECD, Economics Department Working Papers No. 656, 2008.

evidence and empirical findings that lowering corporate taxes raises TFP growth and investment.”⁸⁹

- A study by the European Commission concludes: “[A] first reason for expecting non-Keynesian effects of fiscal policy emerges...when a current expenditure cut is expected to be offset by a reduction in future distortionary taxes.”⁹⁰
- A Federal Reserve Bank of Cleveland study reports: “Output, however, is lower due to the decrease in the capital stock. The charts show that the convergence to the new steady state is gradual. The new steady-state capital stock is reduced by 7.7 percent, and output by 1.2 percent. Private consumption is 7.3 percent lower than it was before government spending rose. Increases in government expenditure cause output to decline because an income tax is distortionary.”⁹¹

Many of the problems cited in these studies occur because personal income tax and corporate income tax rates are non-trivial. It is not realistic, however, to believe that direct taxes if applied would remain at very low rates. The history of every country which has imposed direct taxation belies such optimism.

Fourth, direct taxation would be extremely deleterious to the very mobile financial services industry. Cayman's system of indirect revenue-raising has been a key factor in the growth of the financial services industry. And since the industry, directly and indirectly, accounts for more than 50 percent of economic output, policymakers should be very sensitive to any policies that would threaten Cayman's future.

Any direct tax system, especially a direct tax on income, would put the Cayman Islands at a competitive disadvantage compared to other international financial centers. There are larger financial centers in other nations that have the advantages of easier communications and economies of scale. There are many financial centers that have a cost advantage. The industry in Cayman has been able to offset these factors because of an attractive revenue-raising regime. It is difficult to imagine how the industry would prosper if that changed.

It might be possible to exempt the financial services industry from direct taxation, but this would create potential problems among groups and organizations that view

⁸⁹ Asa Johansson, Christopher Head, Jens Arnold, Bert Brys, and Laura Vartia, "Tax and Economic Growth," OECD, Economics Department Working Papers No. 620, 2008.

⁹⁰ European Commission, Directorate-General for Economic and Financial Affairs, "Public Finances in EMU, 2003," European Economy, No 3, 2003.

⁹¹ Charles T. Carlstrom and Jagadeesh Gokhale, "Government Consumption, Taxation, and Economic Activity," Federal Reserve Bank of Cleveland Economic Review, 3rd Quarter, 1991.

such regimes as “discriminatory” and “unfair.” Industry-specific tax preferences also may be inconsistent with European Union policies or World Trade Organization rules, and it is unclear how the United Kingdom would respond to complaints.

Last but not least, the lack of direct taxation is an important aspect of Cayman’s image as an attractive business location. So even if a tax were imposed that somehow protected the financial services industry, it is quite possible that there would be indirect costs as the Cayman Islands lost its special allure.

Fifth, establishing and maintaining a system of direct taxation in the Caymans would necessitate extensive compliance. The Legislative Assembly would need to pass legislation of immense complexity, and a new court system would be required to deal with tax issues. Government would need to expand significantly with legal draftsmen, tax assessors, and tax collectors. Such problems would be compounded by tax code complexity, which afflicts almost every income tax system. As noted in a previously-cited OECD study:

“...the increasing complexity of the tax system may be harmful for growth. Complex tax codes tend to result in high tax compliance costs that can lead to a loss of efficiency as resources are wasted to comply with the tax system instead of being put into productive use. It may also contribute to make the business environment less friendly....”⁹²

Value-Added Tax

Most of the discussion above is directed toward taxes on incomes -- both personal and corporate. We also analyzed proposals for a Value-Added Tax, or VAT, for the Caymans. After some research, we concluded that this form of tax likewise would harm the Cayman economy and its people.

A VAT is a tax on consumption and therefore would reduce consumption of the taxed services. There is no evidence of which we are aware that suggests the introduction of a VAT would actually increase the size of the economy. In Cayman, if a VAT were introduced with normal zero ratings and exemptions were introduced as a replacement for all other taxes, it would shift some of the revenue-raising base away from the financial services sector to the rest of the economy, especially the tourism industry. A VAT would cut into the amount of the average tourist spends. That money would be lost to tourism businesses, which account for some \$500 million of Cayman’s

⁹² Asa Johansson, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartia, “Tax and Economic Growth,” Organization for Economic Cooperation and Development, Economics Department Working Papers No. 620, 2008.

GDP⁹³ and account for some 5,000 jobs.⁹⁴ There would be no “magic” increase in overall Government revenues from a VAT. Indeed, the tourism industry would be expected to argue for compensation through the abolition of existing Government revenue levies such as hotel bedroom charges and the cruise-ship departure charge.

The VAT would bring additional problems.

When assessing the potential for introducing a VAT, it is necessary to consider the U.K.’s compliance and collection experience. Based on official VAT Theoretical Tax Liability (“VTTL”) calculations it is estimated that there is a VAT gap (tax estimated as due but not collected) of between 11.85 and 15.4 percent.⁹⁵ Applying such an estimated percentage loss of revenue to a Cayman VAT with a target of raising, say \$200 million (to replace import duties of around \$160 million), results in a VAT gap loss of up to \$30 million. It can be seen from these broad estimates that an attempt to raise 15 percent more revenues through a VAT might actually result in raising no more than current import duties. In practice, revenues would likely be even lower because of the negative impact on the revenue base and the likely loss of employment in the tourism sector.

Introducing a VAT into the Caymans would require the passage of a completely new law. This would expand Government, as additional parliamentary draftsmen, prosecuting lawyers, compliance officials, and collection staff would have to be added. A new VAT tribunal and court system would also be required. Political pressures to adopt different rates for different goods and services would lead to increased complexity and hence a need for even more civil servants.

In the recent report on the U.K.’s Offshore Financial Centers, the following concerns were expressed over possible negative impacts of introducing a VAT (1) inflation and competitiveness; (2) loss of revenue; (3) adverse effects on aggregate demand; (4) distributional effects on the cost of living, total employment, and consumer surplus; and (5) administration cost increases.⁹⁶

⁹³ The bond Offering Memorandum estimated tourism accounted for 16.1 percent of Cayman’s GDP in 2008.

⁹⁴ Number of jobs is a Commission estimate based on the Cayman Islands Statistical Office’s Labor Force Survey 2008, Table 8a, using the numbers set out under Hotel, Restaurant and (part of) Transportation.

⁹⁵ As calculated by HM Treasury in the Pre-Budget Report of 2008.

⁹⁶ HM Treasury report on Offshore Financial Centres published in October 2009.

Added to the above is the potential for a badly-managed VAT to place at risk the sustainability of the Government's finances through what has become known as "carousel fraud".⁹⁷

Finally, initiating a VAT typically requires two or more years of costly change, including time to obtain the support of business people and the population at large. Great difficulties have been encountered by smaller countries, and some have withdrawn their VAT systems.⁹⁸ The current circa 120 Customs staff would have to carry on collecting import duties while being trained on how to collect a VAT. Also, training of businesses (their accountants and advisers) plus political leaders would be required. It is a disruptive exercise for any country to undertake.

For those reasons and more, we recommend that Cayman not introduce a VAT.

2. Orchestrate substantial privatization and other asset sales.

There is a way Government could raise receipts that would not have an adverse effect on the Cayman economy and would actually improve the functioning of the economy: privatization and other asset sales. While the potential to obtain receipts is limited, such sales and receipts are essential to bridge the financial transition from excessive spending to more healthy revenue growth.

The Government should implement a rapid privatization program by concentrating on enterprises and programs that meet one of four criteria whereby the enterprise/program is: (1) already under review and discussion for privatization, (2) a viable commercial activity with a revenue source independent of Government subsidies, (3) the type of activity for which there is already a considerable global track record of successful privatization and a competitive cadre of consultants, operators, investors, and bankers with experience in privatizing such activities, and (4) a commercial function that is a drain on Government revenues and needs immediate attention.

Cayman opportunities fulfilling the first criteria include the sewage system and the new Government office building now under construction, and both should be pursued and completed by the end of FY2009/2010 (that is, June 30, 2010). The Government estimates that these two opportunities, plus the sale of two fire trucks, would yield as much as US\$85.8 million (CI\$71.5 million).⁹⁹

⁹⁷ Carousel fraud is explained in Michael Keen, VAT Attacks, IIMF Working Paper 2007.

⁹⁸ Grenada withdrew its original system because it was deemed to be too inflationary but is trying a new version. Malta withdrew its systems and replaced it with a sales tax.

⁹⁹ Source: bond Offering Memorandum, September 19, 2009.

Water Authority

The Cayman Water Authority provides both potable water and wastewater treatment to parts of Grand Cayman by way of two separate systems with separate sets of fees and revenue streams that make it relatively easy to restructure the company and sell the sewage component as a separate entity. At present, potable water is sold by volume, while sewage services are sold at a flat fee based on the number of bedrooms and bathrooms of residences, and similar measures of size for commercial properties. Combined, the Authority's two services are reported to have a book net worth of CI\$30.5 million (US\$ 36.6 million). Annual revenues are running at CI\$28.1 million, yielding a surplus (profit) of CI\$2 million, while serving about 12,000 customers.

The water supply component of the Authority has not been discussed for privatization, perhaps in part because it already operates in a public/private partnership with Consolidated Water, a private, Cayman-based company listed on the NASDAQ. Consolidated has built and operates four desalinization plants that provide the potable water distributed by the Authority, as well as a few more desalinization facilities whose water is sold directly to Island users not served by the Authority. In effect, the Authority is a distributor that resells water provided by Consolidated.

At present the Government is seeking an independent valuation of the sewage system, and this estimate will serve as a benchmark to evaluate bids received in response to a formal offer to sell the system. While waste water treatment and sewage systems are a frequent target of privatization efforts, there are no commonly used metrics (say value per customer, or per gallon treated) that would provide a rough guide to valuation estimates. Factors such as rate base, rate regulation, environmental regulation, growth prospects, age and technology of the facility and related infrastructure are important determinants of value, in addition to the size of the operation. In its FY2009/2010 budget documents Government estimated that sale of the sewage operation would achieve CI\$20 million.

Office Building

The Government has also announced its intention to sell and lease back its office building that is now under construction. The recent bond Offering Memorandum estimates that the building will be worth US\$126 million (CI\$105 million) when completed. However, the building is not yet complete and is expected to be sold while still under construction. The Cayman budget now estimates the proceeds of the sale at CI\$50 million. To the extent that Government still plans to occupy the building upon its completion, the nature of the lease arrangement will have a significant effect on the building's valuation regardless of cost to complete.

Real Estate

In addition to the office building, the Islands' Asset Registry lists an extensive collection of physical assets owned by the Government. While many reflect the usual collection of assets commonly used by any service organization – buildings, IT equipment, construction in progress, vehicles – and therefore not generally available for disposition, a notable opportunity may be Government's land holdings, estimated to have a value of CI\$287 million. We view this figure as speculative -- it could be much more. We are also aware of a certain freehold conversion proposal ("Dragon Bay") which would net Government some CI\$34 million.¹⁰⁰ We urge Government to undertake serious analysis of land values, with the prospect of monetizing a regular flow of such assets as accomplished by the U.K. government and local authorities for over 25 years.

Other Immediate Opportunities

The bond Offering Memorandum and budget also propose new investments in the airport (a longer runway to accommodate direct flights from Europe) and better port facilities (to accommodate large cruise ships and to give all cruise-ship passengers more convenient access to the Grand Cayman). In each case the Memorandum indicates that these construction goals might be accompanied through some sort of a public/private partnership (PPP). While PPPs are an important technique in harnessing the talent and the financial resources of the private sector to provide public services, the PPP concept includes a variety of approaches, all of which generally fall short of actual privatization, where the asset is transferred to private-sector owners and investors. In the case of the longer runway at the airport, a PPP arrangement could have a private investor finance and build the new runway for, say, a share of future landing fees, but the airport would still be owned and operated by a Government authority. A similar arrangement may be envisioned for the ports.

While these are both innovative ideas, the better solution would be to privatize both the airport and the new port facility, as both facilities meet the second and third criteria listed above, and also partially meet criteria (1), as the previous paragraph indicates. Privatizing these initiatives, rather than orchestrating partnerships, would result in higher returns to Government and quicker, and likely more efficient, development of the projects.

Cayman Islands Airport Authority

The airport on Grand Cayman currently earns an estimated CI\$25 million annually in total revenue, of which CI\$8.7 million is provided by various public entities.

¹⁰⁰ Dragon Bay: Presentation to Caucus, November 5, 2009.

In FY2008/2009, the user contribution was CI\$13.6 million. The remainder of the revenues are earned from various fees derived from users. Without public revenue contributions, the Authority would be running at a loss.

Airports have been successfully privatized over the past few decades. Beginning with the U.K.'s privatization of Heathrow, Gatwick and Stansted in 1987, many nations in Europe, Asia, and Latin America have privatized their major airports either by contracting out operations through a long-term lease (30 years or more) with a leasor/operator or through sale of the entire operation to an owner/investor/operator. Since 1987, airports in Vienna, Copenhagen, Frankfurt, Hamburg, Rome, Naples, Athens, Brussels, and both Orly and De Gaulle in Paris have been privatized.

In Asia, Australia offered 99-year leases for its airports and received \$3 billion for the Sydney airport, while New Zealand privatized airports at Auckland and Wellington. Airports in Thailand, Japan, Hong Kong and India have been privatized or are in the process of being privatized. In the Americas, Mexico privatized several dozen airports in a phased sale over a period of years, while long-term concession contracts have been used in Argentina, Bolivia, Chile, Columbia, Ecuador, Peru and Jamaica. Similarly, in a number of places where the air traffic control system is separate from the airport authority, the air traffic control system has been privatized or commercialized into an independent, not-for-profit corporation. As such, there is an active global market for airport acquisition, and there is a considerable amount of expertise capable of bringing such an effort to a swift conclusion is readily available.

There are a number of benchmarks that analysts use to determine an airport's approximate value. One benchmark that some analysts have used is a multiple of EBITDA (earnings before interest, taxation, depreciation and amortization). According to reports, prior to the recession, airport buyers/investors had been paying an average of 15.6 times EBITDA for airports. At present, the Cayman Airport Authority is technically operating at a loss (when the public subsidy is excluded), so it would be difficult to calculate value using the normal EBITDA method.

An alternative valuation method is through measures of per-passenger throughput, since it is the passengers who directly and indirectly provide the revenues to the airport. For example, last year the ownership of Gatwick airport in the U.K. was resold for a sum of US\$2.4 billion. As Gatwick served about 32 million passengers that year, the sale price is equivalent to a valuation of US\$75 per passenger. However, in recent months the new owners of Gatwick sold a 12 percent share in the airport to an Asian pension fund for US\$156 million, implying an overall airport valuation of US\$1.3 billion, or a per-passenger valuation of \$40 per passenger.

On the basis that the Cayman airport might serve about 800,000 passengers this year, and because it is loss-making, applying a low rate of \$25 per passenger results in a valuation of US\$20 million (CI\$16.5 million). In addition to whatever proceeds might be received through the sale, Government would save an additional CI\$8.7 million per year that it now provides as an annual subsidy payment.

Obviously this is a broad estimate. In the end, the sale price would be based upon such factors as the age of the airport's many infrastructure components, conditions that may be included in the sale (a requirement to build a longer runway of a specific type, for example), regulation of fees, labor agreements, and future projections of the Island's business and tourism markets. The early release of a Request for Information may be the effective way of discovering investor interest and potential valuation.

Port Authority

The Cayman Islands Port Authority is funded entirely by fees and receives no direct subsidies from Government. This year's revenues are expected to be down about 5 percent from last year, to an estimated CI\$19.6 million. The Authority lost money last year and is expected to lose CI\$458,000 in FY2009/2010. The book net worth is reported at about CI\$40 million. Government's current plans to invest in an upgrade of the port's infrastructure to better serve the cruise industry could be made a part of any privatization/concession arrangement, thereby freeing Government from the obligation to issue, service, and guarantee the debt. Privatization could also provide Government with revenues related to the asset's sale or concession

As is the case with airports, marine terminals have been the target of successful privatization efforts over the past decade or more, and several of these privatizations and concessions have led to substantial facility upgrades. In the U.S., Ports America Outer Harbor LLC will upgrade and operate 5 container berths in the Port of Oakland through a 50-year concession, and total investment by the company is expected to be near \$150 million. Virginia received an unsolicited bid from CenterPoint Properties for a 60-year public-private partnership to operate marine terminals in the Hampton Roads area, including a commitment to invest \$2.4 billion in a new terminal on Craney Island. The Maryland Port Authority recently requested proposals from private-sector investors and operators to fund, build, and operate a new 50-foot berth and to increase capacity at Baltimore's marine terminal.

Unlike many airports which have been sold outright to investors in whole or in part, many port "privatizations" have occurred by way of long-term concessions in which a private business takes over the operations of the port or some portion of it for a defined period of time, and in the process agrees to undertake a series of investments

to improve service and capacity. In return, the private business receives all or some of the fees earned at the facility for which it is responsible.

To date, most of the port privatizations/concessions that have occurred have been at marine facilities that handle cargo, not cruise-line passengers, so there are not many benchmarks or examples by which to make judgments about how such an opportunity would be valued.

Given Government's current fiscal situation, the advantages to the economy (and derivatively to Government in the form of higher revenue), and the expected costs of upgrading the port's cruise-ship capacity and convenience, we recommend that Government move quickly in issuing a Request for Information to interested and eligible parties, stating the level of responsibility it is looking to divest, the potential scope of revenues, the infrastructure upgrades required, and the time frame expected.

Turtle Farm

Part tourist attraction, part conservation program, part provider of turtle meat for sale to the public, the Cayman Islands Turtle Farm operates at a significant loss that appears to have been recently covered by an CI\$9 million "equity" investment by Government. In the current fiscal year (2009/2010) the Farm is projected to earn CI\$6.6 million in revenues through its various lines of activity against expenses of CI\$17.7 million, for a projected loss of CI\$11.1 million. Apparently the CI\$9 million injection was necessary to meet debt service requirements. In February 2010, the Farm tripled the price of the meat it sells to CI\$33 per pound in an effort to raise revenues.

It seems likely that the Farm will continue to lose substantial sums of money and require ongoing subsidies that may be as high as CI\$10 million per year, given current losses. Government should restructure the entity into its three component parts – meat, tourism, and conservation -- and seek buyers for each or all. Given its losses to date and its limited revenue projection, asset sale proceeds could be limited, and potentially complicating such a transaction are the Farm's liabilities of CI\$51 million, which exceed book assets by CI\$15.2 million. To the extent that Government is a guarantor of the debt of the Farm, it could suffer a loss if prospective buyers refuse to accept the debt along with the assets, in which case closure and sale of the land might be the most cost-effective solution.

Stock Exchange

Modest in scope, the Cayman Islands Stock Exchange is projected to have revenues of CI\$1.4 million this year and yield a surplus of CI\$188 thousand. It is one of the few, perhaps only, government-owned stock exchanges in the free world, and as such may be missing out on opportunities to expand and innovate, given the Cayman

Islands' favorable tax environment and its international financial expertise. A well-publicized Request for Information would reveal the range of possibilities, and revenues to Government if sold.

Development Bank

The Cayman Islands Development Bank is a Government-sponsored and subsidized institution that provides credit in support of business opportunities that might otherwise not be able to acquire credit. It received CI\$577 thousand in subsidies in this and in the previous fiscal year. Last year it ran at a loss, but projects a modest surplus in this fiscal year, though absent the Government subsidy its loss would equal about 20 percent of revenue. Assets are CI\$36 million and exceed liabilities by CI\$5.7 million. As an established financial institution with an existing portfolio of assets the Bank could be an attractive acquisition by private investors, and yield an attractive sale price, if it is given the freedom to operate as a full-service commercial bank according to the banking laws of the Islands, rather than as a public institution whose investments are limited to enterprises of questionable creditworthiness. At a minimum, its privatization might allow Government to avoid the full extent of the annual subsidy payment.

Summary of Reform Opportunities

Among the 25 Government-owned enterprises/authorities that operate as pseudo-businesses, the six described above, as well as the other saleable assets, are the best candidates for privatization over the next year or two. In large part this is because all are involved in a type of commercial activity that is typically performed by for-profit private businesses. As Table 9-1 reveals, the remaining public authorities that have been organized to operate in a business-like fashion are not good candidates for sale because the service they provide is one typically provided by the public sector and not likely to survive as a for-profit business. Table 9-1 lists all of the Cayman Statutory Authorities and State Owned Enterprises, as well as our summary recommendation for the type of action or privatization that might be applied to them in order to reduce costs and improve service.

In addition to the six authorities described above that are recommended for privatization over the next two years, the remaining 18 are recommended either for a phased reduction of the existing Government subsidy, or as a candidate subject to review for competitive contracting of some of its functions. Cayman Airways, for example, is projected to receive a Government payment of CI\$10.5 million this fiscal year. If this subsidy were to be reduced in equal increments over the next three years, a total of CI\$21 million would be pared from spending over that period, and annual savings of C\$10.5 million would occur each year thereafter. Other authorities that should be subject to a phased reduction in subsidy payments include the National

Insurance Company, the National Museum, the Health Services, National Housing Development Trust, and the Public Service Pension Board. Combined, these six authorities are projected to receive Government subsidies of CI\$181 million during the current fiscal year.

**Table 9-1: Recommended Types of Reform
to be Applied to Cayman Islands Authorities**

Authority	Privatization	Phased Subsidy reduction	Increased Competitive Contracting
Cayman Airways Limited		Yes	
Cayman Islands Airport Authority	Yes		
Cayman Islands Development Bank	Yes		
Cayman Islands Monetary Authority	No	No	No
Cayman Islands National Insurance Company Limited	No	Yes	Yes
Cayman Islands National Museum		Yes	
Cayman Islands Stock Exchange Limited	Yes	No	Yes
Cayman Islands Cultural Foundation			Yes
Cayman Turtle Farm (1983) Ltd.	Yes		
Children and Youth Services (CAYS) Foundation			Yes
Civil Aviation Authority	Possible		Yes
Electricity Regulatory Authority			Yes
Health Services Authority		Yes	?
Information Communication and Technology Authority	No	No	Yes?

Maritime Authority of the Cayman Islands	No	No	Yes
The National Drug Council			Yes
National Gallery of the Cayman Islands			Yes
National Housing Development Trust	No	Yes	Yes
National Roads Authority			Yes
Port Authority of the Cayman Islands	Yes		
Public Service Pension Board	No	Yes	Yes
Sister Islands Affordable Housing Corporation	No	No	Yes
Tourism Attraction Board			Yes
University College of the Cayman Islands	Yes		Yes
Water Authority	Yes		

While we believe that Cayman Airways should receive urgent attention and should be required to become financially self-sufficient within three years, the other five should be subject to a five-year subsidy payment phase-out. If accomplished in equal, annual reductions, this five-year plan would yield an annual savings of CI\$36 million during the first year of implementation. The cumulative savings over the five-year phase-out period would be CI\$541 million.

The remaining 12 authorities should be subject to competitive contracting, as described in more detail in Recommendation 9 in Chapter XI of this report. Extensive studies of competitive contracting in the U.S. and in Europe indicate that cost savings of about 25 percent can be expected from such a program. In the case of the 12 authorities, whose combined operating costs are expected to total CI\$42.8 million in this fiscal year, the application of a comprehensive competitive contracting program could save CI\$10.7 million per year, year after year.

Restructuring Various Operations

In the course of our work, we concluded that Government is now carrying out functions that are not necessarily required and that there is considerable over-employment. Addressing these two phenomena by either restructuring and operating jointly with the private sector or by converting them into truly competitive, efficient enterprises could result in considerable expenditure reductions as well as increases in

Government revenue. We were not able to carry out a detailed study in the time available, but the following functions would seem appropriate for restructuring (staff numbers are shown in parentheses):

- Units that could be restructured into agencies and jointly run with the private business sector:
 - Trade and Business Board (6)
 - Investment Bureau (11)
 - Tourism (55)
- Units that could be formed into Government agencies with competitive market pricing, salary, and pension benefits:
 - Radio Cayman (22)
 - National Pensions Office (6)
 - Computer services (61)

This would restructure 161 civil service posts with a more efficient, market-focused outcome.

We consider that the private business sector in Cayman has much to contribute, in both skills and money, to making the tourism, trade, and investment activities on the Islands an increasing success. We received strong representations to that effect, and we consider that the business community should be called upon to make those functions even more effective in delivering benefits to all Caymanians.

3. Make significant reductions in operating expenses.

As we have communicated throughout this report, the key to restoring the Cayman Islands' fiscal sustainability is making significant reductions in operating expenses. Table 9-2 tabulates core Government operating expenses as a percent of the total:¹⁰¹

¹⁰¹ The numbers in the table are from the Annual Budget Estimates for 2009/10. The 2008/9 numbers are "Estimated Actual" from that source document.

Table 9-2: Components of Cayman Government Operating Expenses

Operating Expenses	2008/9 CI\$	2009/10 Budget CI\$	2008/9 %	2009/10 Budget %
Personnel Costs	252.3	244.0	46.9	45.9
Supplies & Consumables	94.4	103.3	17.6	19.4
Depreciation	17.9	20.5	3.3	3.9
Outputs from Public Authorities	103.0	98.6	19.2	18.5
Outputs - Non Governmental Orgs.	21.7	22.4	4.0	4.2
Transfer Payments	31.9	32.0	5.9	6.0
Other Opex	4.7	4.3	0.9	0.8
Net Deficit in Public Authorities	11.4	6.7	2.1	1.3
Total Operating Expenses	537.4	531.9	100.0	100.0

As can be seen, nearly one-half of core Government operating expenses are personnel-related.

Of the remainder there are very few obvious items for expenditure reduction. Depreciation is a non-cash item which is simply a function of necessary capital expenditure. Its size is more or less fixed for years into the future by the commitments already in existence and the need to replace existing assets.

The items “Outputs from Public Authorities” and “Net Deficit in Public Authorities” indicate where there is potential for significant savings as a result of: (1) privatization, (2) additional competitive contracting; or (3) a simple mandatory cut in operating costs. Based on our experience of both business and government, a 5 percent to 10 percent cut in such costs is nearly always achievable if senior personnel are willing to support their operational unit’s sustainability.

The item “Transfer Payments” may well be capable of a small amount of potential savings if the targeting of payments is not as accurate as it should be. However, we recognize that many of these payments are welfare support to some of the neediest Caymanians, including former seafarers, the unemployed, and those Caymanians receiving grants to study overseas. We would not expect significant savings from this source.

The items “Supplies and Consumables” is capable of delivering some savings, as the fiscal year is well underway with less being spent. However, many of the items under this heading are unavoidable expenditures, in some cases purchased from the

local business community which expects to be supported in difficult times. In some cases the expenditure is for essential items that maintain Government's functions, such as communications and office rental which cannot be deferred. Governments often impose freezes on this category of expenditure, especially when it involves items such as maintenance costs. The savings can be false economies, because deferring maintenance may save short-term cash but often increases costs when has to be carried out at a later date. Nevertheless, a potential for savings is likely to exist, and at least a 10 percent reduction is a sensible target.

We have not included interest charges in the above discussion, as they are addressed elsewhere in this report. The path they are following is upwards at the present time as a result of recent borrowings. The only way to reduce interest charges, when global interest rates are moving upwards, is to improve the credit rating of Government by regaining control over spending or repaying debt or a combination of both.

As can be seen from this discussion, there is only one real source of savings that will make a significant contribution to improving the Caymans' financial sustainability – personnel costs.

The current salary and benefits package for Cayman civil servants is unaffordable, and its cost must be reduced. The following are the reasons:

- In the four fiscal years from FY2005/2006, total Government personnel costs rose by at least 30 percent more than the rate of expansion in the Cayman economy.
- The suspicions of Members of the Legislative Assembly were justified when it was stated that "...the cost of the civil service was strangling the financial resources of this country."
- The level of personnel costs is so high and increasing at such a rapid rate as to threaten the fiscal sustainability of Government.
- On a number of cost and numerical measurement criteria, Cayman's public sector employment comes out at the higher end of the range by international standards. The measures are: the proportion of personnel costs to GDP; the number of government employees relative to the population and to total employment; and cost compared with total Government expenditure. Cayman's total Government personnel cost base is on a par with the most expensive advanced economies in the world, although those countries' civil servants have

both wider and more responsibilities.

- The costs of the Cayman civil service's accrued pension and healthcare arrangements are opaque, and should be made transparent, for all to see, and any accelerated arrangements should be phased out or eliminated as soon as possible.
- The pension benefit is effectively non-contributory, as the Government is paying the employees' contribution as an addition to salary, which is a more generous basis than the U.K. and U.S. civil service.
- Salary increases for senior officials were awarded at excessive levels without regard to long-term implications and affordability.
- Up-to-date financial information in the form of audited financial statements and financial affordability was not available when past decisions were made regarding promotion, salary, and the hiring of additional civil servants.
- The civil service salary scale in use in Cayman is among the most generous of any country in the world.
- The excess personnel cost of the civil service has caused a higher level of borrowing than is reasonable, and that debt burden will have to be repaid by the next generation of Caymanians.
- With better planning and restraint with respect to personnel costs, the two new schools could have been funded from the Government's own resources, without recourse to borrowing.
- There is an enormous unfairness in the current pension policy of the Government. It is very much a two-tier structure, with one group of civil servants benefiting at the cost of another. Civil servants on the defined benefit program are privileged with a "top quality", but unaffordable, non-contributory program, whereas those doing the same or similar work but on the defined contribution plan are having to pay more.

It is absolutely necessary that urgent action be taken to bring under control the costs of civil servants, including those in Statutory Authorities and State Owned Enterprises.

We have previously concluded that Cayman civil service salaries and benefits are unaffordable. Our conclusions were based first and foremost on personnel costs rising faster than GDP. This increase explains almost all of the need to increase borrowings. Taking on ever-increasing amounts of debt in order to finance civil service salaries and benefits is not sustainable over the long term, and in order to preserve the future stability of the Cayman Islands urgent action is necessary.

We recommend the following:

- Civil service salaries

There should be an immediate cut in the civil service wage bill of 8 percent. Because of healthcare and pension cost increases already in the pipeline, this may require an immediate 10 percent cut in salaries. This cut should be implemented in a manner similar to that undertaken in Ireland: up to 15 percent reduction for the highest grades, 10 percent for middle grades, and 3 percent to 5 percent for the lowest grades. An alternative scale of reductions might be applied to the emergency services staff, although we recommend that their work practices be reviewed to ensure that their work is both effective and efficient.

- Civil Service numbers

There must be a reduction in the number of civil servants -- back to the low point achieved in July 2003 -- 3,097. Pending the recommendations of an investigative committee (see below), we recommend that this necessary reduction be achieved at a rate of 5 percent (of total civil-servant employment) each year. In some cases, two or more functions should be combined under one staff member or within business units. In order to achieve this new work pattern, we recommend that Government develop and adopt a Caymanian version of the U.K. government's "more for less" program.

- Civil Service pensions

Effective immediately, the defined-benefit pension program's benefits should be revised to reflect average lifetime earnings instead of two-thirds of final salaries. Also effective immediately, employee contributions to the defined-benefit program should be raised from zero to 12 percent of salary on a similar basis to those civil servants in the defined contribution plan. Civil servants should be offered a choice of either having benefit accruals suspended at today's level or, if they wish, to continue benefit accruing, provided they make the same contribution as a defined-contribution civil servant. Annual increases in pensions

paid in the future should continue, based on a reasonable inflation index, provided that the necessary funding is put in place and overall personnel costs are reduced to an affordable level. The funding should not be left as a burden for future generations who, if the burden is too large, might decide to emigrate. The accrued liability to date should be funded within a reasonable time period of say 5 to 10 years, and the full liability funded within 20 years.

- Civil service healthcare

The extremely generous civil-servant healthcare program should be made transparent. A summary of the actuarial report should be published immediately. An up-to-date legal opinion and actuarial report must be obtained to confirm the extent of the unfunded liabilities. Benefits under the program should be reduced to affordable levels, with some (co-payment) contributions required for treatments.

- Civil service retirement ages

The age for civil service retirement should be raised to 65, except for police and prison officers, but phased in over the next five years so as to ensure that it does not interfere with the policy of reducing the number of civil servants.

- Civil service investigative committee

An investigative committee, similar to Ireland's "Special Group on Civil Service Numbers and Expenditure," should be established immediately. It should be tasked with drawing up a specific five-year plan to reduce the number of civil servants back to the 2003 level. The Committee should also be tasked with proposing reductions or eliminations of programs that are no longer required or where their costs outweigh their benefits. Because of the current lack of explicit controls on resource use, we recommend that the hiring of any new civil servants require the approval of both the Premier and the Cabinet. Progress on the goal of reducing the number of civil servants should be a featured part of each Finance report to Cabinet.

- Statutory Authority and State Owned Enterprise employees

Salaries, pay, pensions, healthcare, and retirement ages for employees in the Statutory Authorities and State Owned Enterprises must be reformed in the same manner as described above. There should also be a reduction in the number of

employees.

- Obligations imposed or encouraged by the United Kingdom

The U.K.'s Foreign Office should be informed that any further new treaty initiatives (other than Tax Information Exchange Agreements) or additional legislative burdens cannot be adopted until fiscal sustainability has been assured, and recent ones are to be either slimmed down or, where clearly beneficial (such as freedom of information), supported in a lower-cost "care and maintenance only" mode.

Results of Adopting Our Recommendations

We now turn to the report's "bottom line": what would it mean for the Cayman Government's fiscal sustainability if it were to adopt our recommendations? Specifically, what would it mean for Cayman Government debt?

In considering this question we draw the reader's attention to the fact that the Cayman Government does not have financial statements that are audited. It is difficult to forecast under such circumstances. Nevertheless, it is important to examine the direction that the Government's finances are moving and to consider the extent to which our recommendations -- if adopted -- would improve the Government's fiscal sustainability.¹⁰²

We have carried out two modeling exercises, using different methods, based on available data:

- Deficit Reversal

In this exercise we examine the impact of our proposed changes on Operating Revenues and Operating Expenses by adjusting the FY2008/2009 actual results. The purpose is to see what steps could have been taken to change that year into surplus if the (deficit) outcome had been foreseen. This approach is particularly useful when considering reductions in expenditures, as it acts as a guide as to how much of a reduction in spending would have been required to achieve a surplus. Another benefit of this approach is that it involves looking backwards at data that, although historic, is at least "actual"; and

¹⁰² In this section, "actual" numbers are those taken from unaudited annual financial statements.

- Forecast modeling

In this exercise we have used as our base the “Forecasted Budget Statements for the Year Ended 30 June 2010” and the Strategic Policy Statement for FY2010/2011, dated November 18, 2009. From that base we have made some key assumptions and then, after making a small number of adjustments based on the seven months’ financial report presented to Cayman Cabinet, made three separate forecasts of the net debt position for the five years ending June 30, 2014.

Deficit Reversal

Table 9-3 shows that had our recommendations been adopted in full on July 1, 2008, there would have been an operating surplus of some \$56 million instead of the actual deficit of \$50 million on June 30, 2009. While the exercise is theoretical, it is a measure of the result that would have accompanied the adoption of our recommendations.

The principal assumptions used in producing Table 9-3 and Table 9-4 are as follows:

- The base-year financial statements of FY2008/2009 (and prior years) are reasonably accurate;
- The unfunded liabilities in the civil service pension and healthcare programs will be addressed separately from the proposals in this section;
- The proposed new revenue sources and expenditure savings will be phased in over time as set out in the table; and
- Privatization and asset sales will deliver at least \$15 million in proceeds each year and will reduce expenditure (subsidies and interest charges) by \$1 million each year. Additional restructuring will produce a further \$1 million reduction in operating expenses.

Table 9-3: Proposed New Revenue Sources and Operating Expense Savings

				Year 1	Year 2	Year 3	Year 4	Year 5
<u>New Revenue Sources</u>				30%	60%	100%	100%	100%
	Volume	\$000	\$m					
1	Duties on Importing High Value Cars	100	10.000	1.0	0.3	0.6	1.0	1.0
2	Additional High Skill Work Permits	1,000	12.500	12.5	3.8	7.5	12.5	12.5
3	Extensions to 7/9 Year Rule	300	30.000	9.0	2.7	5.4	9.0	9.0
4	Tourist fees - Reinstate 800 Hotel Rooms	115,200	0.020	2.3	0.7	1.4	2.3	2.3
5	Annual Road Fund - Rate by Engine Size	1,000	1.000	1.0	0.3	0.6	1.0	1.0
				7.7	15.5	25.8	25.8	25.8
<u>Savings</u>								
	Volume	\$m	\$m					
6	Personnel - Salary/Benefits Cut	10%	196.0	19.6	19.6	19.6	19.6	19.6
	Phasing of Number Reductions			20%	40%	60%	80%	100%
7	Personnel - Number Reduction	640	0.060	38.4	7.7	15.4	23.0	30.7
	Total Personnel			27.5	35.4	43.2	51.1	59.0
Other Savings:								
	Volume	\$m	\$m					
8	- Supplies & Consumables	3%	94.4	2.8	2.8	2.8	2.8	2.8
9	- Output - Salary Cuts	10%	103.8	10.4	10.4	10.4	10.4	10.4
10	- Output - Personnel Reduction	120	0.060	7.2	1.4	2.9	4.3	5.8
11	- Transfer Payments Review	-	-	-	-	-	-	-
12	- Privatization/Restructuring			1.0	-	1.0	1.0	1.0
	Total Savings			42.1	52.5	61.8	71.1	80.4
<u>Tax Reductions and Abolitions</u>								
13	Cancellation of Money Transfer Tax			-	-	-	-	-
Net Savings/Contribution to Surplus				49.9	67.9	87.6	96.9	106.2
Deficit Published as "2008/9 Estimated Actual" in 2009/10 Budget Estimates				- 50.0	- 50.0	- 50.0	- 50.0	- 50.0
Theoretical Net Surplus if All Recommended Changes had Been in Place				- 0.1	18.0	37.6	46.9	56.3

Table 9-4 details the results our recommendations would have had in the fifth year following FY2009/2010 had they been in place at the beginning of the period.

Table 9-4: Impact of Recommended New Revenue Sources and Expenditure Reductions on FY2008/2009 Estimated Outcome (in fifth year)

		Actual 2008/09 \$m	Proposed Changes \$m	Revised 2008/09 \$m
<i>Coercive Revenue</i>				
Levies on International Trade and Transactions	1	166.6	1.0	167.1
Domestic Levies on Goods and Services	2,3,4, 5	238.7	24.8	263.5
Levies on Property		30.3		30.3
Fines		2.4		2.4
Other Executive Revenue		0.0		0.0
Total Coercive Revenue		<u>437.9</u>	<u>25.8</u>	<u>463.7</u>
<i>Revenue</i>				
Sale of Goods and Services		47.5		47.5
Investment Revenue		1.1		1.1
Donations		0.7		0.7
Other Operating Revenue		0.2		0.2
Total Revenue		<u>49.5</u>	<u>-</u>	<u>49.5</u>
Total Operating Revenue		<u>487.4</u>	<u>25.8</u>	<u>513.2</u>
<i>Operating Expenses</i>				
Personnel Costs	6 to 7	252.3	(59.0)	193.3
Supplies and Consumables	8	94.4	(2.8)	91.6
Depreciation		17.9		17.9
Outputs from Public Authorities	9 & 10	103.0	(17.6)	85.4
Outputs from Non-Governmental Orgs		21.7		21.7
Transfer Payments	11	31.9	-	31.9
Other Operating Expenses		4.7		4.7
Net Deficit in Investments in Public Authorities	12	11.4	(1.0)	10.4
Total Operating Expenses		<u>537.4</u>	<u>(80.4)</u>	<u>457.0</u>
Surplus/Deficit from Operating Activities		<u>(50.0)</u>	<u>106.2</u>	<u>56.3</u>

It should be noted that this surplus is calculated before interest charges, which are currently expected to be some \$23 million in FY2009/2010 and \$27 million in FY2010/2011. Furthermore, although the results suggest there is potential for a surplus after interest, it should be noted that cash flow will be impacted negatively by debt repayments of \$25 million each year.

A further call on any cash generated from a “surplus after interest” is the need to incur capital expenditure. In FY2008/2009, depreciation amounted to some \$18 million, compared to an average capital expenditure in recent years of closer to \$50 million.

Therefore, achieving a surplus of \$49 million, while significant, it is barely enough from a cash-flow perspective. It would be approaching sufficiency had borrowings not increased so much.

It is this level of borrowing that is causing so much risk to Government's financial sustainability, and the next exercise is designed to explore that predicament.

Forecast Modeling : Three Scenarios

Forecasts tend to imply certainty, whereas outcomes are often determined by unexpected events. These three different scenarios have been simplified, as they are based on estimates and have been prepared in an environment where full audited data is unavailable.

Three different scenarios have been analyzed:

- Scenario 1 - No change in the flows of operating revenues and expenses;
- Scenario 2 - The Commission's recommendations with respect to operating revenues and expenses are implemented in major part and at the earliest opportunity -- but without any (additional) proceeds from privatization and asset sales; and
- Scenario 3 - The Commission's recommendations with respect to operating revenues and expenses are implemented in their entirety at the earliest opportunity -- and with proceeds from privatization and asset sales.

Assumptions underlying all three scenarios are as follows:

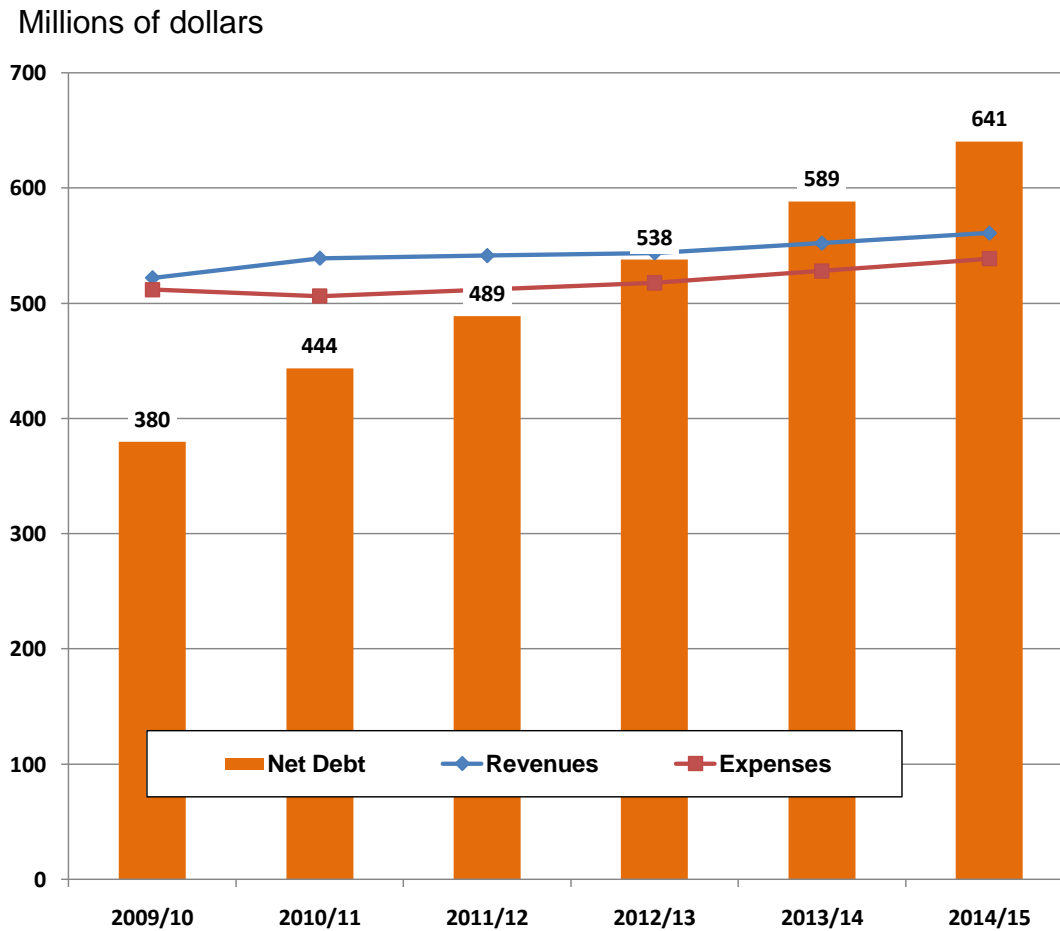
Property and Other Revenues	:	Increase by 1 percent each year
Purchases (Supplies & Consumables)	:	FY2009/2010 budget (includes \$10 million saving from previous fiscal year); thereafter, increases 2 percent each year
Interest Rate	:	6 percent annually on Bonds and Other Finance; 3 percent on bank balances
Asset Purchase(s)	:	Government data to FY2013/2014; then similar trend
Equity Injections	:	Government data for 2011/2012; then similar trend
Repayment of Borrowings	:	Government data from Bond Offering Memorandum

Contingency Set Aside	:	3 percent of expenditures
Fees		FY2009/2010 budget increase of \$95 million, less \$18 million not enacted; FY2011/2012 onwards -- \$126 million less \$21 million (to reflect measures not enacted)
Duties		\$150 million (reflecting FY2009/2010 shortfall); then growth of 1 percent each year
Depreciation	:	Commission estimates -- increase of \$1 million each year
Privatization and capital withdrawal	:	\$51 million sales + \$42 million capital withdrawn from Statutory Authorities in FY2009/2010

Scenario 1, shown in Figure 9-3, is based on two additional assumptions:

- The \$10 million savings in personnel costs in FY2009/2010 is continued throughout the five-year period, but there is no change in the number of civil servants or in their compensation (salary and benefits); and
- There are no additional revenues from privatization or asset sales other than those assumed in the FY2009/2010 budget.

**Figure 9-3: Scenario 1 -- Recommendations Rejected
Net Debt Increases 70 Percent**



As shown in the figure, under Scenario 1, net debt rises rapidly, because the operating surplus is insufficient to pay for interest costs, capital expenditures, and debt repayments. The Government is in breach of the 80 percent Debt-to-Revenues Principle of Responsible Financial Management, as well as two other Principles. There is a continuing need for the U.K. government to approve all borrowing, and fiscal sustainability is extremely unlikely.

Scenario 2, shown in Figure 9-4, is based on two different additional assumptions:

- In addition to the \$10 million savings in personnel costs realized in FY2009/2010, the cost of salaries and benefits is cut 10 percent the first year, and the number of civil servants is reduced 3 percent each additional year.
- There are no additional revenues from privatization and asset sales.

**Figure 9-4: Recommendations Partially Implemented
Net Debt Increases by 20 Percent**

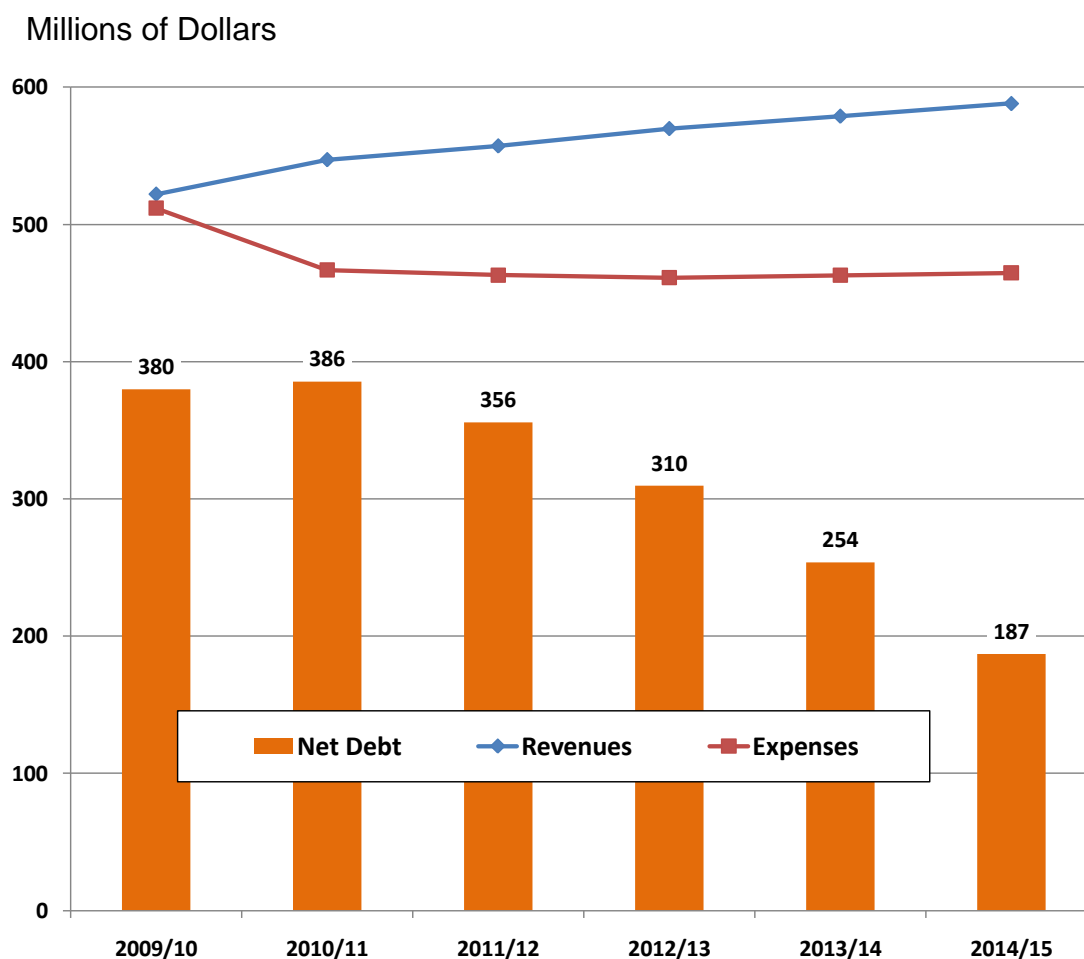


Under Scenario 2, net debt continues to rise and is within a narrow margin of breaching the 80 percent Debt-to-Revenues Principle of Responsible Financial Management. There is a continuing need for U.K. government approval.

Scenario 3, shown in Figure 9-5, is based on yet another set of additional assumptions:

- In addition to the \$10 million savings in personnel costs realized in FY2009/2010, the cost of salaries and benefits is cut 10 percent the first year, and the number of civil servants is reduced 3 percent each additional year (the same assumption as in Scenario 2); and
- Annual privatization, including competitive contracting, plus asset sales of \$10 million per year.

**Figure 9-5: Recommendations Implemented in Full
Net Debt Decreases by Nearly 50 Percent**



Under Scenario 3, net debt falls rapidly, and the prospect of repaying the US\$ 312 million bonds on their repayment schedule is very likely. There is no continuing need for U.K. government approval.

Conclusion

On the basis of the best information available, we believe it is possible for the Cayman Government to strengthen its finances and achieve debt sustainability -- provided it is willing to take quick, and determined, action. It can accomplish its goal without undermining its economy, but only if it takes strong action to rein in an unsupportable growth in operating expenses, of which personnel costs is the most significant item.

X. Recommendations for Improving Budget Integrity and Process

4. Develop and maintain a separate contingency fund.

The Cayman Government's lack of adequate cash reserves hindered its ability to smooth over the decline in revenues during the recent economic downturn. After suffering similar experiences over the past three decades, almost all U.S. states and territories have created contingency or contingency funds that they can draw upon when economic conditions cause a severe or sudden drop in tax revenues. The British Virgin Islands has done the same.

Since economic fluctuations are inevitable, best practices dictate that the Cayman Government develop and maintain a healthy contingency fund. There are a number of residual benefits to doing so.

First, building and maintaining a contingency fund requires prudent fiscal management, budget discipline, and transparency. Thus, it can make all the parties involved in the budget process more responsible and accountable. It sends a signal to citizens that Government has taken steps to reduce the potential for fiscal volatility and avoid the sudden tax and fee increases that were enacted recently.

In addition to lessening fiscal uncertainty, a contingency fund would add to the Cayman's balance sheet which can improve Government's credit rating. According to Fitch Ratings "...maintaining a contingency fund is perhaps the most effective practice an issuer can use to enhance its credit rating."¹⁰³

Indeed, economists have found a relationship between contingency funds and borrowing costs for governments. According to one study:

Compared to states without budget stabilization funds, the results indicate that the typical state experiences nearly a 10 basis point reduction in long-term bond yields following the adoption of a budget stabilization fund, other factors constant. The results also show that states with different deposit and withdrawal rules governing their budget stabilization funds encounter different reductions in borrowing costs. For instance, states with strict deposit and withdrawal rules attached to their stabilization fund are found to experience a substantially larger reduction in tax-exempt

¹⁰³ Darcy Rollins, "Evidence and Analysis of the Relationship of Rainy Day Funds and Municipal Bond Ratings," New England Public Policy Center at the Federal Reserve Bank of Boston, September 25, 2005.

bond yields than states that have stabilization funds governed by less stringent rules.¹⁰⁴

Basics of Contingency Funds

Although a number of nations have established budget stabilization funds with the proceeds of severance taxes from natural resources – Norway’s is funded by oil taxes and Chile’s is funded by copper severances – these are not good models for the Cayman Islands. A more appropriate model are the funds employed by most U.S. states to lessen their fiscal uncertainty. The British Virgin Islands also has a Reserve Fund and Contingency Fund which also could be a model.

According to compilations by the National Association of State Budget Officers and the National Conference of State Legislatures (NCSL), 48 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands have established contingency funds.¹⁰⁵ The only states without such funds are Kansas and Montana. These funds are in addition to the funds most states have also created that are dedicated to natural or man-made disasters.

These funds differ quite widely in their size, how they are filled, how they can be tapped, and how they are replenished. Below is a brief overview of how these funds operate and a specific recommendation for the Cayman Government.

Filling the Contingency Fund

Generally, U.S. states are required by their constitutions or by statute to contribute to their contingency funds according to a formula or rule up to a preset limit or cap. At a minimum, most are required to deposit some portion of year-end surpluses into their contingency funds during good years. For examples, Utah is required to dedicate 25 percent of year-end surpluses to the fund, while New Jersey, West Virginia, and Wisconsin are required to contribute 50 percent of any surpluses to the fund. Others, such as Washington State, are required to contribute annually to the fund irrespective of economic conditions. Washington is required to allocate 1 percent of state general fund revenues into the “budget stabilization fund” every year until the fund reaches a level equal to 10 percent of general revenues.

¹⁰⁴ Gary A. Wagner, “The Bond Market and Fiscal institutions: Have Budget Stabilization Funds Reduced State Borrowing Costs?,” *National Tax Journal*, December 2004.

¹⁰⁵ See: National Association of State Budget Officers, “Budget Processes in the States, Summer 2008,” p. 72; and Daniel G. Thatcher, “State Budget Stabilization Funds,” *National Conference of State Legislatures*, September 26, 2008.

Similarly, the U.S. Virgin Islands must deposit not less than \$5 million each year until the fund is equal to 10 percent of the current year's general fund expenditure.¹⁰⁶

Quite a few states have triggers based on economic conditions or events (such as an asset sale) that require deposits into the fund. At least eight states have multiple funds financed by different revenue sources. This helps diversify the contributions to the fund, since some revenue sources grow faster at different times than others, while preventing the funds from being drawn down too quickly.

Rules for Withdrawal

To prevent the politicization and misuse of contingency funds, many states have established tough conditions that must be met before lawmakers can access the funds.

According to NCSL, 16 states require a supermajority (three-fourths, two-thirds, or three-fifths) to withdraw from their funds. By contrast, economic triggers are used in other states to put the decision making beyond the realm of the political process: after all, budget deficits can be caused as much by legislators as by economic events. Some examples: Officials in the U.S. Virgin Islands can only tap their contingency fund when forecast general revenues decline by more than 15 percent. In Indiana and Michigan, transfers are made only if personal income falls. And Minnesota's Governor may make withdrawals only when a deficit in the general fund is projected and "objective measures, such as reduced growth in total wages, retail sales, or employment, reflect downturns in the state's economy."¹⁰⁷

Replenishing the Fund

Replenishing the fund is just as important as filling it in the first place. While not all states have strict requirements on how the fund should be replenished, those that do vary considerably. For examples, in Florida repayment is made in five equal annual transfers from the general fund, beginning in the third year following withdrawal. New York's two funds must be repaid within six years and three years respectively. In Missouri, one-third of the amount transferred plus interest must be repaid during each of the next three fiscal years, and in Rhode Island, the fund must be repaid in the second year following the year in which a transfer was made -- or, if necessary, in subsequent fiscal years.

¹⁰⁶ Standard & Poor's, Public Finance, U.S. Virgin Islands, September 8, 2006.

¹⁰⁷ Washington State Tax Structure Study, found at http://dor.wa.gov/content/aboutus/statisticsandreports/wataxstudy/Appendix_D.pdf. This document includes a model constitutional amendment and a simulation on how the proposed triggers would work.

Recommendation for Caymans

The Cayman Government should enact a strict set of statutes to govern the creation, maintenance, and operation of a contingency fund:

- The fund should be financed out of general revenues and by revenue windfalls such as asset sales;
- Half of all surpluses should be deposited into the fund until a cap of 10 percent of the previous year's total outlay is met;
- The fund should be available only in the event of revenue shortfalls due to conditions outside of the political process, such as declines in personal income and/or employment;
- Once such a condition were met, assessing the fund should require a two-thirds vote of the Legislative Assembly;
- In the event of any draw-down, the fund should be replenished promptly, but not in a fashion that would stress the budget during an economic recovery -- a good rule being to require payment in the second year following the year in which a transfer was made; and
- The Cayman Government should be as transparent as possible about the operation of its contingency fund and the uses to which the funds are put.¹⁰⁸

A final cautionary note: a well-funded contingency fund can certainly cushion the fiscal system in the short term, but it cannot obviate the need to make difficult programmatic cuts during an economic downturn.

5. Complete audits of all Government agencies, Statutory Authorities, and State Owned Enterprises.

Throughout the course of our work we were struck by the anomaly that the Cayman Islands -- one of the premier financial services centers in the world -- had Government books in appalling condition. Specifically, we note that for most Government entities there have been no audited accounts since 2005. How, we asked,

¹⁰⁸ The website for the Massachusetts rainy day, or contingency, fund is an excellent model for informing citizens about how the fund operates. See http://www.mass.gov/bb/h1/fy2009h1/exec2_09/hbudbrief21.htm.

could policymakers be expected to make proper decisions on the basis of such incomplete, and possibly inaccurate, information?

Accordingly, we recommend that the outstanding annual reports and financial statements of all Ministries, Agencies, Statutory Authorities, and State Owned Enterprises be brought up to date within a six-months period. We recommend that, in consultation with the Auditor General, the Legislative Assembly establish a specific timetable for each entity and that the responsible Government officials be held accountable for meeting those deadlines.

6. Reform the budget process to improve transparency and increase accountability.

In our review of various documents and in our interviews on Grand Cayman, we were struck by the lack of transparency in the budget process and the lack of accountability for the budget's implementation. In theory, the budget process is relatively simple: the financial secretary proposes a budget for the coming fiscal year based on direction from the Premier and other Ministers; this budget is then reviewed by the Premier and the other Ministers, modifications are made, and then the budget is approved by the Legislative Assembly and implemented by the civil service. Despite the importance of the budget, there appears to be only limited discussion of its overall scope and content prior to approval. More vexing is the lack of centralized control over spending. As we understand the process, ministries draw upon appropriated funds from Treasury on an "as needed" basis, and Treasury has little power to assure that spending is actually carried out in accord with plans adopted by the Legislative Assembly.

Specifically, we recommend:¹⁰⁹

First, that steps be taken to make the budget process more visible and especially that Treasury be granted powers to supervise and control outlays, much as similar powers are presently exercised by the U.S. Office of Management and Budget and the U.K. Chancellor of the Exchequer.

Second, that the Legislative Assembly, in consultation with the Auditor General, address the weaknesses in the six Principles for Responsible Financial Management that were identified in opening section of Chapter VI and consider the establishment of a more prudent and enhanced set of principles in the future.

Third, that the budget system be updated, so that all approvals are achieved prior to dissolution of the Legislative Assembly. The system should enable either Party to

¹⁰⁹ Also see discussion of budget process reforms in the concluding section of Chapter VI.

campaign on the basis of proposing further changes in a supplementary Budget if that is so desired.

Fourth, the necessary financial information and support is provided to the Finance and Public Accounts Committees in carrying out their designated functions.

Fifth, that (a) monthly and annual reporting timetables are enforced with support of the Cabinet, (b) that forecasts of revenues and expenditure be extended to five years, in part, to help restrain the growth of operating expenditure and to keep the annualized impact of capital expenditure within the long-term economic growth rate, and (c) that longer-term strategy planning be developed, with particular emphasis on managing contingent liabilities.

And sixth, that the normal democratic process of Parliamentary scrutiny through audit is re-established as soon as possible and that, if necessary, resources be increased in order to enable the necessary financial reporting timetables to be achieved.

7. Improve the accuracy, reliability, and usefulness of data produced by the Economics and Statistics Office.

In our researches and interviews, we found that often Government, civic, and business leaders and officials are encumbered in their decision making by a lack of timely, accurate, reliable, and comprehensive statistics on the Cayman economy and society. The Government Economics and Statistics Office (ESO) has the primary responsibility for the production of economic and social statistics but has been hampered by confusion about its mission, frequent turnover of senior personnel, and a culture of privacy in Cayman -- all of which have made it difficult for users to obtain needed data. Much of the information provided by the ESO, particularly the economic statistics, is not sufficiently timely to be particularly useful. Some data is not merely weeks or months behind, but literally years. Moreover, frequent changes in methodology makes comparisons from one time period to the next problematic. Such problems are particularly pertinent to fiscal matters such as those addressed in this report, since an absence of timely and accurate economic data make the forecasting of revenues and expenditures even more difficult, and poor statistics are likely to lead to inadvertent misallocation of resources by Government officials.

We realize that the production of some internationally standard economic data, such as GDP accounts (including statistics on per capita income and income distribution) is more difficult because Cayman does not have a system of direct taxation. Neither businesses nor individuals are required to collect and report income data, as would normally be the case in countries having direct tax systems. Nevertheless, other jurisdictions without direct taxes have been able to overcome these problems. Also,

there appears to be a lack of cooperation or communication among Government agencies. For instance, as part of its charge the Cayman Island Monetary Authority (CIMA) collects considerable information in a very timely way about the size and makeup of the Cayman financial industry. Yet ESO does not provide this information to the public until months later, even though much of it can be found on the CIMA website for those who know where to look for it.

In many countries, including the U.S. and the U.K., much-needed economic data is published by business and trade associations, because it is in their self-interest to provide accurate, reliable, and current information both to their own members and to the community at large. For instance, the U.S. Chamber of Commerce for many years published an authoritative annual report of employee benefits, which was used by governments as well as industry. Similarly, in the U.K., the Land Registry provides data about real estate sales, prices, turnover, and so forth, and the Land Registry in Cayman could provide similar information.

We recommend that the Cayman Government appoint an independent, non-political Advisory Committee of well-qualified economists, statisticians, and users of economic and social statistics to review the collection and dissemination of statistics in Cayman. The Committee should be tasked with identifying what statistics are required to meet the needs of Government leaders and officials, the business community, international organizations, and other stake holders and with determining whether each set of statistics is best collected by Government (and if so, by which agency) and which by private parties, including business and trade associations. The Committee should also be charged with recommending which statistical functions and activities should be privatized and/or contracted out and which should remain with Government. Upon the completion of its initial work, the Committee should make recommendations as to what changes are needed to update the Statistics Law,¹¹⁰ A new law should ensure that the ESO is an independent, non-political agency and is empowered to require other Government agencies to provide necessary data expeditiously. As a result, the ESO (or its successor) could post data in a more timely fashion.

We believe that Cayman can actually produce much better statistics at lower cost in many cases by having the relevant parties collect the statistics and submit them electronically to the ESO (or its successor) on a real-time basis. To improve the usefulness of all such data and to reduce costs even more, the ESO (or its successor) should be required to post the statistics on an enhanced, user-friendly website and largely forgo the printing of costly, and often out-dated, hard-copy reports.

¹¹⁰ The Statistics Law (2 of 1970), Rev. 1996.

XI. Recommendations for Enhancing Government Efficiency

8. Review Government activities to identify and implement efficiency-enhancing applications of information technology, related reforms, and contracting out.

As the Cayman Islands look for more opportunities to reduce the cost of Government, an expansion in the current program of competitive contracting should be applied throughout Government, to reduce costs and increase the quality of services.

While such programs can be as controversial as asset sales because they threaten the status quo, they can be constructed in a way that is fair to the existing work force and managers by allowing them to compete to hold on to their own jobs. Such a system now operates in the U.S. and in a number of other countries, to considerable success. For example, the U.S. Department of Defense finds that savings of 25 to 30 percent are typical.

The Government of the Cayman Islands should build on its success thus far. As expertise is established in contracting out simpler and less essential service, it could move on to more sophisticated services.

9. Study ways of raising the same revenue but minimizing the adverse effects on economic activity of various levies on the financial services industry, the tourism industry, and the goods and services industry.

From discussions with Cayman political leaders, it is apparent that a principal goal for tax policy is to raise whatever funds may be needed in such a way as to have the least adverse impact on the Cayman economy. This is a laudable goal. From our review of specific revenue measures applied to the three major components of the economy -- financial services, tourism, and goods and services -- we believe there may well be opportunities to raise the same revenue from each while enhancing economic growth. We recommend that Government establish a working group for each of the three industry segments named above to provide recommendations for lessening the economic burdens of taxation on their respective segments while still producing the same revenue to Government.

10. Attract private capital to solve various infrastructure challenges and to develop new enterprises.

Our researches revealed a number of opportunities for projects requiring Government involvement that might well stimulate Cayman's economy. The Government lacks the funds to carry out these investments by itself, even if that is desirable. Accordingly, we recommend that Government facilitate private-sector investment to secure these benefits.

The major initiatives we have in mind are: (1) lengthening the runway, in order to accommodate larger jets and thus more tourists from Europe; (2) constructing a dock to accommodate cruise-ship passengers; (3) reclaiming and relocating the current recycling center; and (4) perhaps providing suitable marina facilities for larger private boats/yachts. We are aware that interest in these and other investments has been shown by the private sector and that some are under serious consideration.¹¹¹ We are also aware that a major initiative on "medical tourism" is under consideration.¹¹² Some of these projects are capable of providing significant revenues to Government within a three-to-five-year time period.

Along the same lines, we recommend that consideration be given to either privatizing University College or enlisting a private company to run the institution. Cayman needs new product lines -- in addition to being a financial and tourism center. As the medical school already has shown, Cayman could become an educational center, attracting students from around the world. In recent years there has been rapid growth of private for-profit colleges, notably the University of Phoenix. Last year, Grand Canyon College was one of the few successful IPO's. Cayman would be an attractive place both for students and faculty, and growth of distant learning technologies over the Internet makes having a combination of in-class and Internet-based education in Cayman feasible. With additional private capital and more entrepreneurial management, University College could exploit such an opportunity. Institutions of higher education tend to provide stable employment, along with demand for many locally-provided goods and services, yet place minimum strain on the environment and infrastructure.

We recommend that all such initiatives that would enhance the Cayman economy, and thus contribute to Government's fiscal sustainability, be given serious, expedited, and favorable consideration.

11. Increase the number of work permits, reduce work permit fees, and make the guest worker program more flexible.

In our interviews on Grand Cayman, we were advised by local businesses that a newly-qualified professional accountant or lawyer will cost a private-sector business about \$80,000 a year in salary and work permit fees, and a senior level professional might cost \$150,000 or more. Using for the purposes of this calculation a cautious figure of \$100,000 for each senior professional and allowing for a low margin of \$50,000 of added value it can be seen that each 1000 work permits granted to businesses could generate a potential \$150 million in gross revenues, provided Cayman stays business-friendly. Of that figure, some \$14 million would be paid to Government in the form of

¹¹¹ For example, Dragon Bay, *ibid.*

¹¹² Narayana Hrudayalaya, 'Grand Cayman: Economic Impact Analysis,' Grant Thornton, January 2009.

work permit fees, and the salaries of \$65 million would result in indirect expenditures in the economy of about \$39 million.

While this scenario is a possible one, the current situation in Cayman is not capable of delivering it, and so we make the following recommendations:

- Government should reduce work permit fees by 5 percent across the board;
- Government should encourage high-skilled business activities to relocate to Cayman by guaranteeing it will issue long-term work permits on an expedited basis to new businesses as well as existing businesses;
- Government should adopt a program of action to make the seven- and nine-year time limit far more flexible for skilled professionals; and
- Government should work with the business community with a view to announcing as soon as possible a program of selling residency and citizenship rights to as many as 1,000 successful global high-net-worth persons who meet appropriate legal vetting criteria and who are prepared to pay substantial sums for such rights.

12. Eliminate the tax on funds exported from the Islands, to lessen the inequity and to quell rumors that the Caymans may well tax other types of fund transfers.

One of Government's new revenue-raising measures is for a new 2 percent fee on all remittances leaving the Cayman Islands via money transfer enterprises. We understand that the average remittance is approximately \$200.

This fee has three negative impacts of particular relevance. First, it burdens the poorest members of the community, many of whom are from neighboring Caribbean countries. It is somewhat incongruous to see Caymanian civil servants on six-figure salaries charging poor (mainly Jamaican) guest workers a fee for aspiring to keep their families at home out of poverty. Second, the fee has led some of Cayman's International Finance Center competitors to claim that Cayman has implemented a tax on all financial transfers. The rumors are exaggerations, but they are still damaging. And third, the fee imposes a financial burden on the businesses affected. We understand that some of those businesses are small and the fee could cause their closure.

The CI\$4.6 million expected from this new fee was based on the CI\$230.0 million that was transferred in 2008. There is reason to believe that the measure will not raise the

amount forecast, and, especially in view of the reputational impact, it has been unsuccessful and counter-productive. Accordingly, we recommend that this particular fee should be cancelled.

XII. Postscript

Just hours before this report was submitted, we received a preliminary forecast of FY2009/2010 budget results. It confirms that the original revenue projections were optimistic. Indeed, rather than achieving a small surplus, the Cayman budget for the fiscal year is now forecast to run a deficit of some \$56 million (for all of government).

Our specific observations about the preliminary forecast are as follows:

- 1) Revenues – A significant part of the shortfall is because the global economy is only now beginning to recover. But some also is due to the likelihood that the additional fees enacted this year are higher than businesses can afford if they are to remain competitive. That confirms our view that business cannot afford to pay more in revenues and remain competitive, even though total revenues may be inadequate to meet the totality of escalating operating expenditures, debt servicing costs, capital expenditures, and debt repayments.
- 2) Personnel Costs – Although these are below budget because of a “no recruitment” policy, they are still close to half of operating expenses -- a level that is clearly unsustainable.
- 3) Other operating expenses – Some small savings have been made, but the Statutory Authorities and State Owned Enterprises are likely to incur costs in excess of budget.
- 4) Operating deficit – This is better than last year, but after allowing for interest charges the improvement is substantially reduced.
- 5) Asset acquisitions and cash flow impact – Only \$33 million of \$141 million budgeted for asset acquisitions has been spent to date. Another \$70 million is planned for the next four months. If asset sales are planned carefully around this capital expenditure, enough cash flow should be available to enable completion of some or all of the projects.
- 6) Asset sales – These were originally budgeted at \$51million (net amount). Current planning is based on a possible \$92 million of asset sales. At the moment, none of the \$92 million can be regarded as confirmed or committed asset sales. Without those asset sales, cash and bank balances are most likely to be around \$70 million, which would breach the 90-day’s expenditure cash requirement set out in the Principles of Responsible Financial Management. However, if asset sales do take place, compliance with this Principle is possible.
- 7) Cash withdrawn from Statutory Authorities and State Owned Enterprises – Some \$7 million has been extracted to date, and a further \$33 million is due to be paid in June. We understand these payments include the total reserves of the Cayman Islands Monetary Authority. This is a “one off” withdrawal that cannot be repeated without damaging the value of the Cayman currency.

- 8) Cash Flow Position – The forecast is that cash and bank balances will actually increase if all the budgeted asset sales and cash withdrawals are completed (the cash balance will rise from \$90 million at last fiscal year's end to \$150 million at this fiscal year's end). The “one off” cash items should ensure enough cash flow to meet the \$25 million of debt repayments due for the current fiscal year.

Whereas the FY2009/2010 budget was designed to comply with each of the Six Principles of Responsible Financial Management, under the forecast, the Cayman budget fails to comply with three of the six of them.

- Core government revenue minus core government operating expenses plus net non-operating revenues and expenses (net surpluses after extraordinary items) should be positive, but a deficit of \$56 million is forecast;
- Debt servicing costs should not exceed 10 percent of core government revenue, but debt servicing is forecast to be 10.5 percent; and
- Net debt should be no more than 80 percent of core government revenue, but net debt is forecast to be 86.6 percent

In addition, as noted in #6 above, there is a substantial risk that the 90-day cash reserve requirement will be breached.

What this latest, preliminary forecast points out is the importance of taking the actions we have recommended. Further revenues, levies, and charges would only undermine an already weakened economy and could cause irreparable harm. It also highlights the importance of raising revenue through privatization and asset sales. Finally, it demonstrates that cutting expenses is not only a long-term solution to the problem of fiscal sustainability but a short-term imperative.