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Saving Cayman: The Miller Commission

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Annual income twenty pounds, annual expenditure nineteen pounds nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery. (Mr Micawber by Charles Dickens)

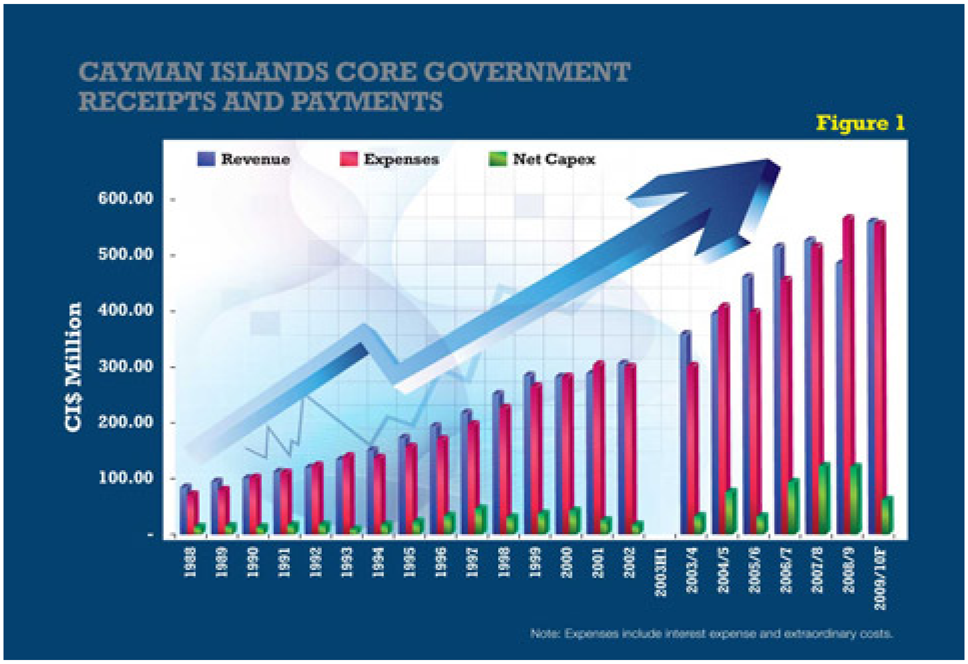
Over the last several years, Cayman picked up the same bad habit that has infected many governments in the world, including most of Europe, notably Greece, Spain, Ireland and the UK as well as the US; and that habit was allowing government expenditures to grow more rapidly than GDP and government revenue. Such trends are unsustainable; and unless corrective action is taken, most will suffer a decline in their standard of living or worse – misery!

When the new government of Cayman Premier Bush was elected last year, it was faced with a rapidly rising budget deficit and soaring government debt. The UK's Foreign and Commonwealth Office – which has some oversight responsibility for Cayman – demanded that the Cayman government come up with a solution to the problem or no more government borrowing would be allowed. It was agreed that an independent commission would be formed to analyse the situation and recommend solutions.

US economist, James C. Miller III, was named chairman of the Commission. Mr Miller was a member of President Reagan's Cabinet and served as head of the Office of Management and Budget for the United States and as a member of the National Security Council. Previously, he served as chairman of the US Federal Trade Commission. Mr Miller was the first person ever to manage a budget of more than one trillion dollars; and during his term as budget director of the US, the deficit and government spending declined as percentages of GDP. David Shaw was selected as the member of the Commission from the UK. Mr Shaw had served in the British Parliament for ten years, and sat on committees dealing with both taxation and expenditure. Mr Shaw is a Chartered Accountant and serves as a director of both profit and non-profit organisations and as a corporate advisor. The third member of the Commission was Kenneth Jefferson, the financial secretary of the Cayman Islands. Mr Jefferson is also a chartered accountant, having worked as an accountant in both London and Cayman.

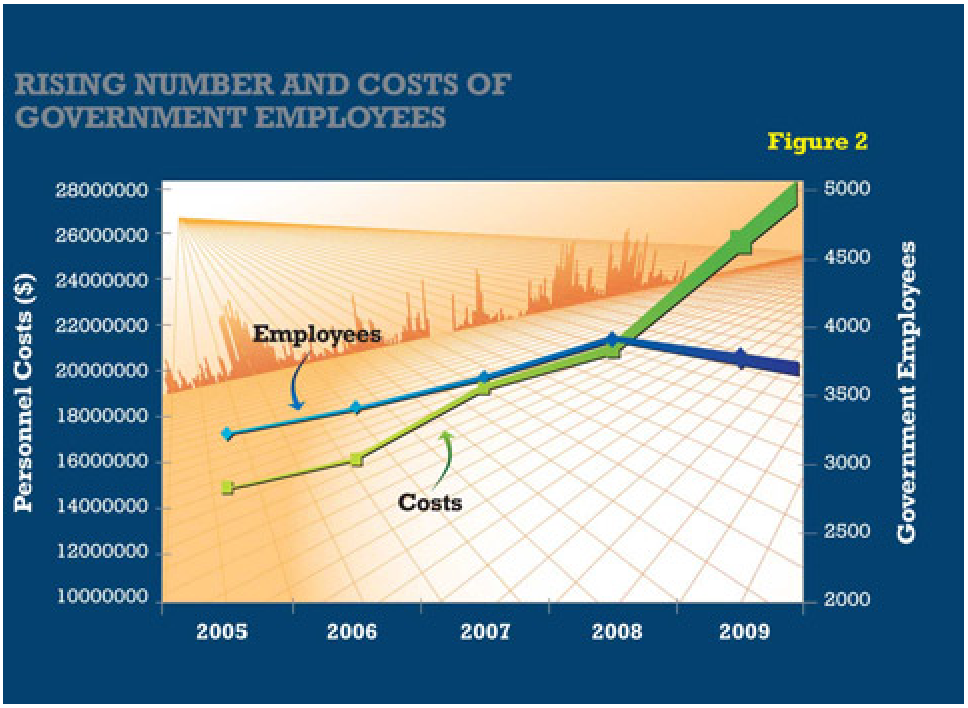
Mr Miller acquired the services of several very experienced and highly-regarded economists who have had considerable international and government experience, including Dan Mitchell, senior fellow of the Cato Institute, Ronald D. Utt, now a senior fellow of the Heritage Foundation, and Scott Hodge, president of the non-partisan Tax Foundation.

The fundamental problem Cayman faced was that, while nominal GDP had only grown at an average annual rate of 2.2 per cent over the last four years and total operating revenues were growing at an average annual rate of 5 per cent, total operating expenses were growing at an average annual rate of 9 per cent. This clearly is a trend that cannot be sustained. It is impossible for a country to get out of a fiscal dilemma by increasing taxes when the government is growing more rapidly than GDP. If the rate of government spending growth can be reduced to the rate of GDP growth, no new taxes are needed. (See Figure 1)

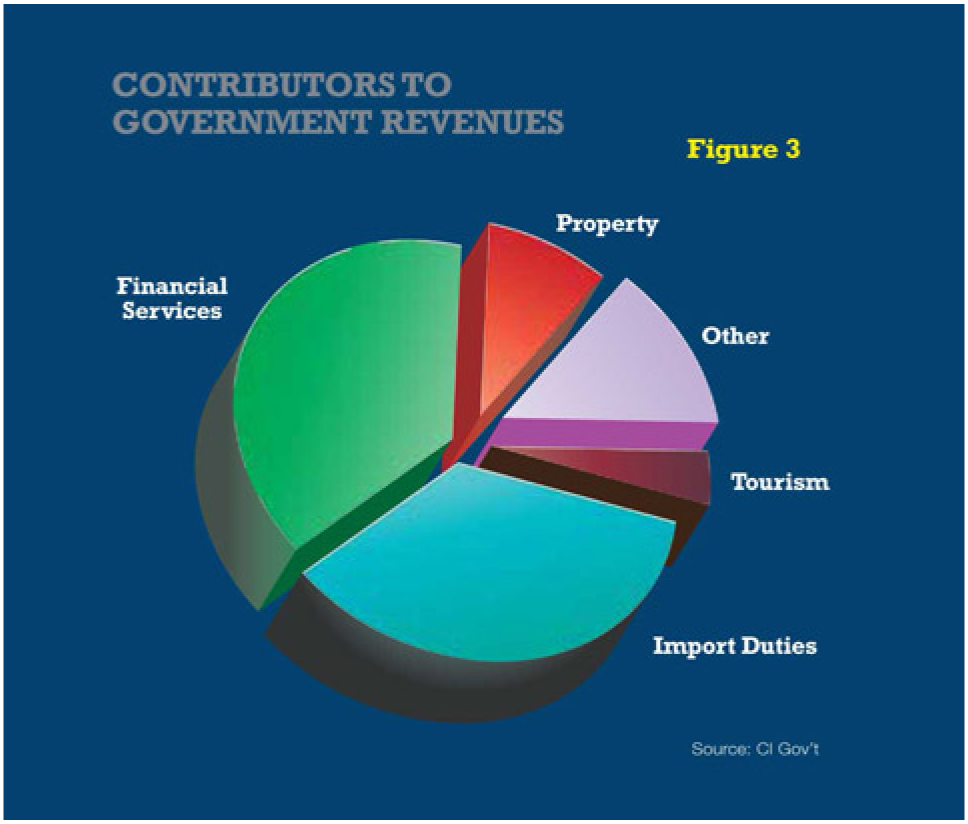


Cayman had succeeded extremely well for most of the last several decades by making sure that the size of the government did not grow faster than the real economy. The economy had grown rapidly, which did allow a great increase in the absolute size of government without increasing its relative burden.

The biggest single cost item in the Cayman budget is personnel. Government employee compensation consumes almost 50 per cent of the total government budget (about the highest in the world), as contrasted with the UK at 25 per cent, and Austria, Luxembourg, and Germany, all at less than 20 per cent. Cayman government payroll costs increased from 11.9 per cent of GDP to 15.2 per cent of GDP in just the last four years. As the Miller report stated: “This rate of expansion cannot continue in the long run 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.’” Cayman civil servants have among the most generous pension and health care benefits in the entire world, which greatly exceed what most civil servants receive in the UK and the US. (See Figure 2)



Cayman is almost totally dependent upon its tourist business and the financial sector, and even much of the tourist business is driven by the financial sector. Both of these lines of business face very stiff international competition. Cayman competes with many lower-cost tourists' centres throughout the Caribbean, and its competitor countries, all being much larger, are able to offer attractions that Cayman cannot. The financial sector is under attack by both existing and new foreign competitors. There is also a growing effort by some major European governments, as well as the US government and international organisations, to so increase taxes and regulations on companies operating in offshore jurisdictions as to take away much of Cayman's competitive advantage. Cayman is also very dependent on the health of the US economy. A recession in the US takes a major toll on the Cayman tourist and financial industries. Because of all of these factors, Cayman has little room to manoeuvre, and a major error in government economic policy could prove almost fatal to Cayman's financial industry. (See Figure 3)



The members of the Commission were well aware of the narrow confines in which Cayman must operate. The Commission took a careful look at the Cayman tax structure and reviewed the pros and cons of instituting direct income taxes, payroll taxes, a value-added tax and a property tax. In all cases, the Commission determined that adopting one or more of these new taxes would impose far more costs than benefits to Cayman. A major attraction of Cayman is the fact that there are no direct taxes on income. To institute one might so damage the financial sector that Cayman would cease to have an internationally viable financial industry. Without the financial industry, Cayman would be a much poorer place.

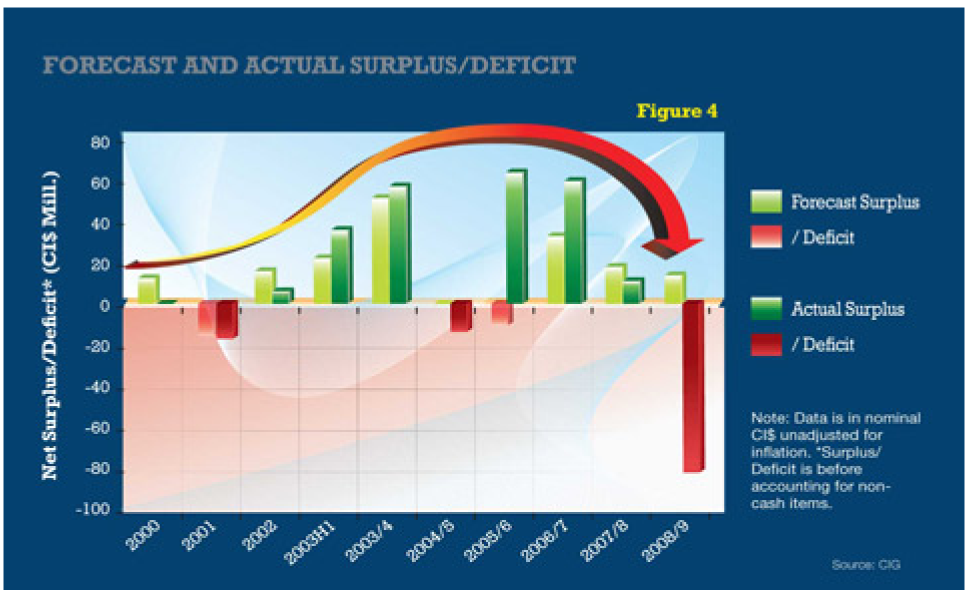
The existing import tariffs effectively serve as a consumption tax on goods, and attempts to increase most of the existing rates would lead to more smuggling and also damage the tourist industry. Cayman derives a considerable portion of its revenue from taxes and fees on the financial industry, and most of these appear to be at close to, if not (in some cases) beyond the revenue-maximising rate. Any further increases are likely to drive away business rather than increase revenues. Thus, Cayman finds itself in a tax box in that increases in taxes will drive business elsewhere rather than add revenue to the government coffers. California, New York and other high-tax US states provide evidence that increasing taxes can make a jurisdiction worse off rather than better off, as these high-tax states have seen many of their most productive citizens and businesses leave for the greener pastures of low-tax states like Texas.

The Commission found that Cayman does have a one-time chance to reduce its debt burden by privatising the Cayman Islands Airport Authority, the Cayman Islands Development Bank, the Cayman Islands Stock Exchange, the Cayman Turtle Farm, the Port Authority of the Cayman Islands, the University of the Cayman Islands and the Water Authority. In addition, it recommended a phased subsidy reduction for many of the other authorities.

The Commission also found that the government accounting and auditing functions were very deficient for providing insufficient information and providing opportunities for abuse. Specifically, the Commission recommended that the budget process be reformed to “improve transparency and increase accountability”, and that complete audits of all government agencies, statutory authorities and state-owned enterprises be prepared.

The Commission also recommended an increase in the number of work permits, coupled with a reduction in work permit fees. The members of the Commission also advised that the guest worker programme be made more flexible.

The good news is that the Cayman problems are readily solvable but will take both political courage and a willingness, particularly among the civil servants, to make the necessary changes. As the Commission reported: “It should be possible for the Cayman Government to restore and maintain fiscal sustainability by undertaking major cuts in spending, by privatising enterprises and by selling other assets.” (See Figure 4)



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