The Cayman Islands

A Balanced Budget

Report on the effects of the introduction of direct taxation commissioned by Cayman Finance

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He writes and speaks regularly on international taxation, particularly as it affects low-tax jurisdictions and international finance centres, and has been published and cited in five continents. His book *The Benefits of Tax Competition* is the leading work on the subject.

He also advises on tax reform, and acted as Expert Adviser to the Scrutiny Panel of the States of Jersey during the recent fundamental reforms to Jersey's tax system.

A qualified chartered accountant, and a law graduate from Oxford University, he previously worked as a tax adviser in the 'Big 4' accounting firm Deloittes and for the major London City law firm Denton Wilde Sapte.

Introduction

The Cayman Islands are facing a fiscal challenge – the government has incurred a budget deficit in 2009 financial year of some $80 million, which it has financed so far by borrowing money through a $325 million bond issue.

The question before the Cayman Islands now is what to do about the deficit given that it is reasonable to suppose that until such time as the global economy recovers further deficits may be incurred in the current and future years. The options suggested are to raise taxes to meet expenditure, to cut expenditure to meet revenues, or continue to borrow more money.

However, at no time in their 200 year history have the Cayman Islands imposed any direct taxes, a fundamental fact which has helped them to build a highly valuable financial services industry.

This report examines the options to determine the best route to secure the future prosperity of the Cayman Islands and its people.

Part 1 – Effect of raising taxes

High taxes damage the economy

Study after study has shown that raising taxes – above the basic level needed for a functioning civil society – damages economic growth and makes that society poorer.[1]

Taxes increase the cost of what is taxed, whether that is investing, starting up a business or working. And when the cost of something is increased you will get less of it - less investment, fewer businesses, fewer jobs. In contrast lower taxes result in more savings, more investment in productive plant, more entrepreneurism – more jobs.

Just a few quotations from dozens of detailed studies illustrate this:

> *"Growth in government stunts general economic growth. Increases in government spending or taxes lead to persistent decreases in the rate of job growth." (Federal Reserve Bank of Dallas)*[2]

> *Tax increases "result in a net efficiency loss to the whole economy … even if the government engages in exactly the same activities - and with the same degree of*

[1] Several of these studies are listed at the end of this paper. But for summaries of dozens of reports from across the world on this issue, see Leach, G., "The negative impact of taxation on economic growth", Reform, London, 2003, Mitchell, D., "The Impact of Government Spending on Economic Growth", Washington, 2005, and Teather, R., "The Benefits of Tax Competition", IEA, London, 2005.

[2] Fu, D., Taylor, L. & Yücel, M., "Fiscal Policy and Growth," Federal Reserve Bank of Dallas Working Paper 0301 (2003)

> *efficiency - as the private sector with the tax revenue so raised."* (IMF)[3]

> *"Higher total government expenditure, no matter how financed, is associated with a lower growth rate"*[4]

> *"Growth is inversely related to the share of government consumption"*[5]

There are also many well-known examples of high taxes causing economic disaster, not least the UK in the 1970s. Conversely there are also examples of lower taxes resulting in prosperity, including:

- The UK and US in the 1980s Thatcher / Reagan reforms;
- New Zealand in the early 1990s;
- Ireland in the 1990s and beyond;
- Slovakia after 2000.

Perhaps the most extreme example of this is Hong Kong – for long a British colony but with a high level of self-rule including the right to set its own tax levels. As a result as the UK reached a basic rate tax of 35% and a top rate of 98% in the 1970s, Hong Kong kept its low taxes and high thresholds. The relative economic growth of the two jurisdictions is remarkable:

[3] Tanzi, V. & Zee, H., "Fiscal Policy and Long-Run Growth," IMF Staff Papers, Vol. 44, No. 2 (1997)

[4] Miller, S. & Russek, F., "Fiscal Structures and Economic Growth at the State and Local Level," Public Finance Review, Vol. 25, No. 2 (1997)

[5] Barro, R., "Economic Growth in a Cross Section of Countries," Quarterly Journal of Economics, Vol. 106, No. 2 (1991)

GDP per capita, constant 1990 $ [6]

	1950	1973	1999
UK	6,907	12,022	19,030
Hong Kong	2,218	7,104	20,352

Whilst the UK's economy over that period grew by only 175% (very little considering the huge advances in technology and global trade that were happening then), Hong Kong's growth over the same time was a remarkable 800%, even after allowing for inflation.

How great is this damage?

Although quantifying the detrimental effect of high taxes is difficult, various economists have studied it and the overwhelming result is that there is a significant impact.

A recent, widely quoted, study for the OECD[7] found that an extra 1% of GDP taken in taxes would reduce economic growth by around 0.6%. Other studies reach different figures – some higher, mostly lower – but they all tend to agree on the principle that higher taxes reduce growth.

With this damage to the economy, plus the cost of collection and administration of taxes, the true cost of an extra £1 of government spending is therefore not £1 but probably more like £1.75.

[6] Maddison, A., "The World Economy", OECD, Paris, 2003, and Bartholomew, J., "The Welfare State we're in", Politico's, London, 2004.

[7] Bassanini & Scarpetta, The Driving Forces of Economic Growth: Panel Data Evidence for the OECD Countries, OECD Economic Studies, No. 33, 2001.

Although 0.6% of GDP may sound small, the cumulative effect of this reduction in growth over a few years can be significant. An illustration of the possible effect on the Cayman economy is given in Part 2.

Even business taxes hurt workers

It might be thought that taxes could be levied only on businesses, or only on the rich, and so the rest of the population will not be affected. That is a fallacy, and a dangerous one.

Businesses are not real people, so if a business's taxes are raised, it has to either close down or pass that extra cost on to someone else. There are really only three options for who to pass that cost on to:

- Owners and investors, through lower profits, lower dividends;
- Customers, through higher prices; or
- Employees, through lower wages or redundancies.

In today's global markets, investors will soon pull their money out of businesses that do not give them a good enough return. Customers also will buy elsewhere if a business increases its prices. So the only people left to bear the pain of higher taxes are the employees. The pain of tax rises on businesses therefore ends up falling on the workers.

A recent study by Oxford University[8] has shown that if taxes on businesses are increased, 75% of the cost of that tax is passed on directly to the employees.

Moreover, the ones who will lose most will tend to be the least well off – the unemployed, those whose jobs are most at risk of unemployment, and those on very low incomes whose jobs will be made more precarious by higher taxes on their employer.

Direct taxes are worst of all

More detailed studies into the effect of different taxes find that direct taxes (income tax and corporation tax) are the most damaging type, far more harmful to the economy than sales taxes or other consumption taxes.

Consumption taxes are often said to hurt the poor, but in fact it is taxes on business that hurt low-income workers the most – although the damage is less easy to see because it is through lowered wages and job cuts.

[8] Devereux, Arulampalam & Maffini, "The direct incidence of corporate income taxes on wages", Centre for Business Taxation WP09/17, Oxford, 2009.

Part 2 – Effect on Cayman

Standard effect of higher taxes

Let’s first look at the effects of raising taxes as if Cayman would be no worse affected than any other country.

Cayman’s GDP is around CI$ 2,350m (United Nations figure). Increasing taxes in the order of $100m, to cover the likely deficit, would therefore be a tax rise of 4¼% of GDP.

As we saw above, an OECD study estimated that each extra 1% of GDP taken in taxes could reduce economic growth by around 0.6%. But even if we take a lower figure of just 0.3%, more in line with other studies, that means raising Cayman taxes to cover the government’s deficit would, assuming we apply the OECD assumptions, reduce GDP by over 1¼% annually for as long as the taxes remained in place.

The cost of this, in terms of the reduced Cayman Islands economy, would be approximately:

- CI$ 60m by the end of the second year; and
- CI$ 145m after five years.

If average employee costs were around $60,000 p.a. (including overheads), that reduction in GDP after five years could be equivalent to 2,500 jobs lost.

Specific effect on Cayman

But the OECD assumptions may not be relevant to the Cayman Islands and in fact the full effect of raising taxes on the Cayman Islands economy is likely to be much more severe, because a large part of the Cayman economy is built on the highly mobile financial services industry.

This means that the Cayman financial services industry will be quicker to react than, for example, a manufacturing business with heavy investment in fixed plant and machinery.

The financial services industry, and its related support businesses such as lawyers and accountants, is of huge importance in the Cayman Islands, providing:

- 55% of Cayman's GDP;
- Over 12,500 jobs – 36% of all employment;
- 40% of all government revenues;
- Over 30,000 business visitors.[9]

That, around two fifths of all jobs and government revenues, is what is at risk if new taxes are introduced.

How severe is that risk? This is a highly mobile industry, and one that is highly sensitive to tax changes. The Offshore Financial Services Industry is based on competition. To give just a couple of past examples of tax driving away successful finance businesses:

[9] Oxford Economics, "Economic Benefits of the Financial Services Industry in the Cayman Islands" (2009)

- The London eurobond market was created in 1964 when the USA started levying tax on bond interest. Corporate borrowing, and the associated trading, was swiftly relocated to London.
- In the run-up to the introduction of the European Union's Savings Tax Directive, which imposed a minimum tax on certain investments in EU and related territories, Hong Kong (which was outside the scope of the Directive) reported that its collective investment fund deposits soared by 56% in just one year.[10]

The Cayman Islands offer more than just a low tax environment for international finance; in addition stability, a fair, successful business-friendly regulatory and legal environment based on Common Law, expertise in innovative financial products, a location that is beneficial for in- and out-bound investment with the USA, and a good reputation that includes strong relationships with international bodies tacking money laundering and financial crime are highly relevant.

However the ability for client funds to move in a tax-neutral environment is an essential condition of much of this financial services work. If that is lost, then the core of the finance industry – and the critical mass that makes it successful - could be lost also.

Twenty years ago it was possible to have a direct tax system that exempted these vital parts of the tax system, taxing businesses

[10] For these and other examples, see Teather, R., "The Benefits of Tax Competition", IEA, London, 2005.

that operate on the island but exempting the vehicles that hold and invest client funds. But what might have been possible then is not so today.

Over the last ten years, the governments of the large economies have been imposing their view of how a tax system should operate on the rest of the world, for example through the Organisation for Economic Co-operation and Development's Harmful Tax Practices initiative, and the European Union's Code of Conduct on business taxation.

A fundamental principle of these initiatives is non-discrimination – if you have a tax, then it must apply to everyone. It is therefore no longer acceptable to have a direct tax system that exempts the large number of funds, trusts and companies that are needed to service the finance industry.

The Cayman Islands therefore risk much more from new taxes than most countries. Not 1¼% of GDP but two fifths of all jobs and government revenues.

Part 3 – Alternatives to raising taxes

Having concluded that raising taxes would be disastrous for the Cayman Islands' economy – and that imposing direct taxes such as income tax or corporation tax would be particularly damaging – there are only two alternative policy routes:

- Debt finance, continuing to borrow money; or
- Reducing public expenditure.

Both of these alternatives will be examined below.

Debt finance

Debt finance should not be regarded as an ongoing solution.

As well as the economic problems of debt finance – which would be even more extreme for a small country than for the UK or USA – it would be highly damaging to the Cayman Islands' reputation as a place to do business. Serious doubts would be cast on Cayman's financial, fiscal and even political stability if deficits were allowed to continue annually. Unlike major G20 jurisdictions, the Cayman Islands cannot print money and issue debt.

As we saw in Part 2, tax rises would have a devastating impact on the Cayman economy – but the fear of future tax rises could be equally damaging, causing businesses and investors to regard Cayman as a fiscally unstable jurisdiction.

A deficit can only be eliminated by either raising taxes or lowering spending. The longer the Cayman Islands government refuses to cut spending, the more likely it is that taxes would have to rise to maintain spending levels and service debt obligations – and businesses and investors will begin to factor this into their decision as to where to invest.

Other offshore finance centres include an absence of debt as part of their marketing. For example Jersey Finance says, as one of the attractions of Jersey as a financial location:

> *Jersey has no Financial Stability problems. We have no government debt, a £500m Strategic Reserve and a £140m Stabilisation fund. We saved in the good years to prepare for the lean years and they have come, as they always do.*
>
> *Jersey Finance, 31st March 2009*

If the government does not demonstrate the political will to tackle the deficit, then the perception of fiscal risk will increase. But in addition the deficit will come to be regarded as a political risk, since the population will be led to believe that the level of government spending is acceptable.

It is therefore important for the Cayman Islands' reputation that the deficit is dealt with quickly. And since that cannot be done by levying direct taxes or by on-going borrowing, the only option is to reduce spending levels.

Reducing government expenditure

It is not within the scope of this report to propose specific areas where spending can be cut without damaging essential services.

However it is possible to compare the level of government spending in the Cayman Islands with that of similar countries and territories, to see whether total spending levels are in line with comparable, and often competing, jurisdictions.

When that comparison is made, it becomes clear that the Cayman Islands government is wholly out of line with its peers, having far higher levels of public spending than any other comparable jurisdiction. This is the same whether we look at total spending or spending per head of population.

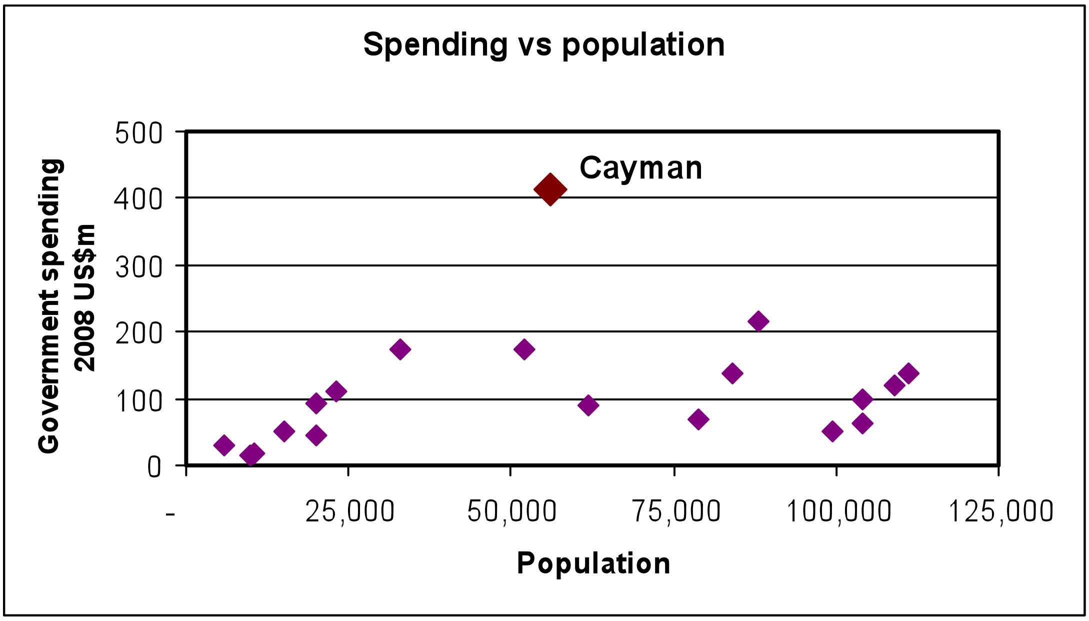
The comparator group chosen is non-Europe countries and territories with a population between 5,000 and 125,000.

This gives a group of 19, roughly half in the Caribbean and half elsewhere.

Full details of the members of that group, the source of data, and the actual spending levels, are given below.

Based on UN data for this group, the Cayman Islands are immediately prominent as having levels of government spending massively higher than the other members, both in absolute terms and when compared to the size of the population.

The chart below compares total government spending (for 2008, in US$) for the members of the comparable group (see below for details of group membership).

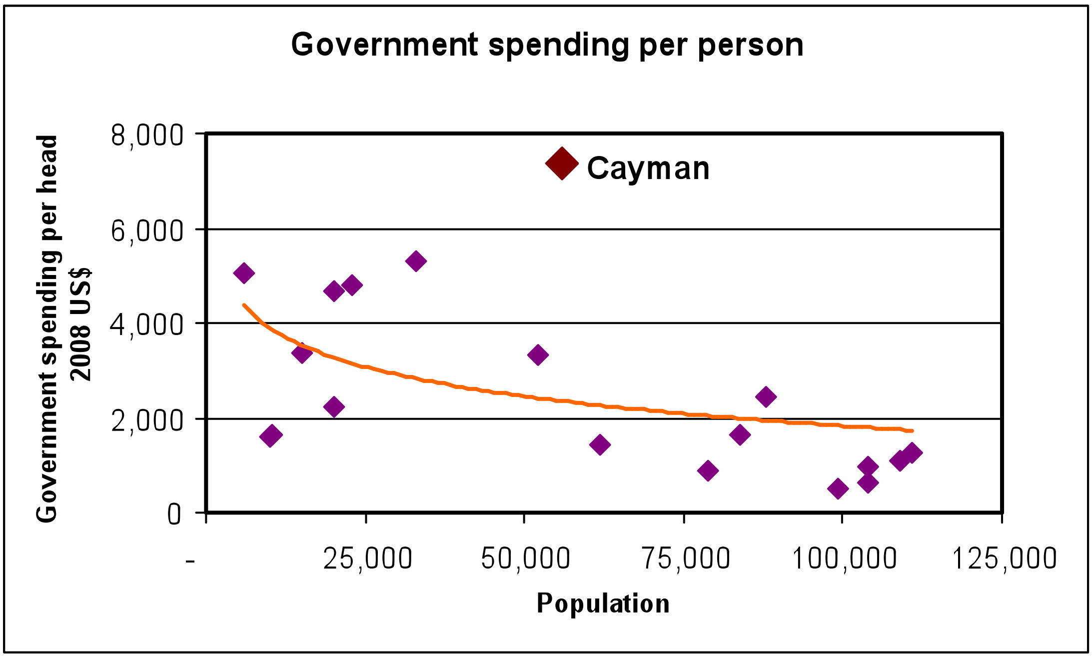


As can be seen from the graph, and the tables below, spending by the Cayman Islands government is almost:

- Twice the level of the next highest (Antigua & Barbuda, which has a higher population of 88,000); and
- Two and a half times the level of the nearest jurisdiction with a similar population level (St. Kitts & Nevis, population 52,000).

All countries in the group are in a similar situation to the Cayman Islands, in terms of having relatively small populations and having the logistical problems of being relatively remote islands.

The same picture is seen when we look at government spending per head of population. The chart below uses the same group of 19, and the same UN data on spending levels:



Government spending per head of population in the Cayman Islands is:

- Over twice as high as the average level for comparable countries; and
- Almost 40% higher than the next highest (Turks & Caicos Islands).

Moreover, the group overall shows that spending per head is generally lower for those with higher populations (presumably due to economies of scale in government operations). However the Cayman Islands break this trend, by having significantly higher spending per head than both smaller and larger countries.

Note on government spending data

The comparator group chosen is all the non-Europe countries and self-governing territories with a population between 5,000 and 125,000 (with the exception of Bermuda, for which UN data was not available). This gives a good range, with the Cayman Islands roughly in the middle in terms of population.

Data on government spending was from the United Nations National Accounts database, using 2008 data (the latest available for comparisons) and in US dollars. Spending data may not match national accounts, because they will all have been prepared on a standard basis to allow comparisons to be made.

		Government spending, 2008, US$	
Country / territory	**Population**	**total**	**per person**
Montserrat	5,900	29,877,778	5,064
Nauru	10,000	15,917,100	1,592
Tuvalu	10,441	17,233,658	1,651
Anguilla	15,000	50,548,148	3,370
Cook Islands	20,000	44,930,723	2,247
Palau	20,000	93,161,338	4,658
British Virgin Islands	23,000	110,046,457	4,785
Turks and Caicos	33,000	174,636,591	5,292
Saint Kitts and Nevis	52,000	172,239,591	3,312
Cayman Islands	**56,000**	**412,937,317**	**7,374**
Marshall Islands	62,000	89,843,405	1,449
Dominica	78,940	68,537,720	868
Seychelles	84,000	137,479,041	1,637
Antigua and Barbuda	88,000	215,307,407	2,447
Kiribati	99,350	50,672,137	510
Grenada	104,000	99,722,222	959
Tonga	104,000	64,166,636	617
Saint Vincent & Gren.	109,000	118,303,297	1,085
Micronesia	111,000	138,665,701	1,249

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