CAYMAN ISLANDS GOVERNMENT

2014/2015 BUDGET ADDRESS

MAINTAINING THE PATH OF FISCAL PRUDENCE

PRESENTED BY: HONOURABLE MARCO ARCHER

MINISTER FOR FINANCE AND ECONOMIC DEVELOPMENT

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INTRODUCTION

Mr. Speaker, it is my pleasure to rise today to speak to The Appropriation (July 2014 to June 2015) Bill, 2014.

Last October when I presented the Government's Budget for the current 2013/14 financial year I spoke of how the Government would, as a matter of policy, be managing the country's economic growth by practicing fiscal prudence. Today, Mr. Speaker, I am pleased to report that we have made much progress in this area and the Government is well on its way towards achieving our desired financial targets. Hence I have entitled my address today – "**Maintaining the Path of Fiscal Prudence**".

I would compare Government's finances to that of a long journey and draw reference to the ancient Chinese proverb *"A journey of a thousand miles begins with a single step."* The financial management issues which led to the imposition of the Framework for Fiscal Responsibility (FFR) did not arise overnight and it is not reasonable to expect that they will disappear overnight.

We must recognize and acknowledge the mistakes of the past and then set about correcting them in a manner that minimizes the risk of reoccurrence.

Mr. Speaker, consistent with the Strategic Policy Statement Tabled in the House on 21 November 2013, the Government's 2014/15 Budget is based on four guiding policy strategies:

1. **Prudent Financial Management;**
2. **Facilitate Private Sector Economic Growth;**
3. **An Educated, Work Ready Populace; and**
4. **Develop and Modernize our Infrastructure.**

The Public Management and Finance Law includes the FFR as its Schedule 6, and prescribes a specific set of fiscal parameters within which the Government must operate its financial affairs. Last year, we agreed that the Cayman Islands Government would achieve compliance with all of these targets by 30 June 2016 and this 2014/15 Budget represents year two in the three year plan towards full FFR compliance.

Therefore, Mr. Speaker, prudent financial management is at the center of this strategy to achieve FFR compliance and involves:

1. strict expenditure control;
2. enhanced revenue collection and management;
3. stringent cash management to build reserves; and
4. proactive debt management to reduce the public sector debt balance.

The 2014/15 Budget expands on all of these points. In line with the FFR, the 2014/15 Budget will reduce the tax burden of the private sector, continue the downsizing of Government and further reduce our debt burden. All of these are expected to provide the private sector with more resources and generate a multiplier effect that will re-grow the middle class and facilitate more robust economic growth over the medium term.

Mr. Speaker, the revenue burden as indicated by the ratio of the central Government's revenue to nominal GDP was 23.6 percent in FY 2012/13.

This increased marginally in FY 2013/14 to 24.0 percent of GDP due to the impact of the revenue measures that were implemented starting from 2012. For FY 2014/15, the aim of fiscal policy is to reduce the revenue burden to 23.2 percent of GDP. This will be realized by reducing the rates of particular taxes. I will speak on this in greater detail in the latter part of my speech.

The Government continued to downsize in FY 2013/14 as evidenced by the decline in total spending at 22.0 percent of GDP compared to 23.4 percent of the previous fiscal year. For FY 2014/15, the aim of fiscal policy is to further curtail the central Government's expenditure to 20.7 percent of GDP.

Consequently, the debt burden of the Government declined in FY 2013/14 to 20.2 percent of GDP from 22.0 percent in FY 2012/13. For FY 2014/15, we intend to further reduce the debt burden to 18.5 percent of GDP.

With respect to developing and modernizing our infrastructure, along with providing world-class educational opportunities at every level, everyone will agree that our long-term economic development is dependent upon our ability to maintain and upgrade our country's physical infrastructure. The Government has identified five such projects that will be pursued as a matter of priority: 1) The George Town Cruise Ship berthing facility; 2) Owen Roberts International Airport Terminal upgrades; 3) George Town revitalization; 4) extension of the east-west arterial road; and 5) a new solid waste management facility.

2013/14 FINANCIAL FORECASTS

Mr. Speaker, I will spend a few minutes to explain the forecast financial results for the current 2013/14 fiscal year as they form the basis for the financials in the 2014/15 Budget.

As at 30th April 2014, the forecast operating surplus for the financial year ending 30 June 2014 is $108.1 million. This figure represents a $7.9 million positive change to the operating position when compared to $100.2 million in the approved 2013/14 Budget. The change in operating position is mainly due to higher than expected operating revenues.

Mr. Speaker, I find it important to explain why the Government's forecast Operating Surplus for the 2013/14 fiscal year does not mean that same amount is available for use at the end of the fiscal year.

The Cash-Flow Statement for the 2013/14 fiscal year indicates that the normal operating activities of the Government – that is, its ordinary recurring revenues minus its recurring expenditures such as Personnel costs, interest expense on past borrowings and cost of supplies and consumables – are expected to generate positive cash flows during the 2013/14 year of $119.2 million. This $119.2 million is used to fund Capital Expenditures and Equity Investments – such as the cost of road-works and providing assistance to Statutory Authorities and Government-Owned Companies. Capital Expenditures and Equity Investments are expected to reduce Government's cash balances by $41.2 million during the year to 30th June 2014.

Therefore, the $119.2 million derived from Government's operating activities is reduced by $41.2 million, to become $78.0 million. However, it is necessary to go on to consider the fact that Government has to make debt principal payments during the year, in respect of borrowings made in the past. For the 2013/14 fiscal year, such financing activities result in a further cash outflow of $24.2 million. When this latter amount is subtracted from the $78.0 million just mentioned, Government's cash balances are expected to increase by $ 53.8 million in the year to 30th June 2014.

Mr. Speaker, this does not mean that the Government is able to spend the $53.8 million increase in cash balances that are expected to arise during the 2013/14 year because, Government has to build-up its cash balances to a sufficient level, by 31 December 2015, to cover 90 days of its normal recurring operating expenditures.

Again, the net operating cash flows are forecast to be $119.2 million which will be used to fund Capital Investments of $41.2 million; make principal debt repayments of$24.3 million and build our cash reserves by $53.8 million.

The revised revenue forecast of $652.1 million is $7.4 million more than the $644.7 million in the 2013/14 approved budget and is due mainly to economic growth and greater efficiency in collecting revenue.

The forecasted 2013/14 operating expenses of Core Government is $547.7 million or $1.7 million lower than the $549.4 million originally budgeted in 2013/14. This resulted from a deliberate and concerted effort of the Government to carefully manage its expenditure within the approved limits.

Therefore, **Personnel Costs** are forecast to be $3.3 million less than budgeted as a result of a deliberate effort to centralize the approvals for the recruitment of staff along with careful scrutiny to ensure that Agencies are only hiring to fill critical vacancies.

Mr. Speaker, **Financing Expenses** are forecast to be lower than the original 2013/14 budget by $0.8 million due to limited use of the $46 million operating overdraft facility and successfully negotiating lower interest rates in November 2013 to reduce interest expense by $6.2 million over 10 years on five outstanding loans with balances totaling $102.7 million.

These savings were partially offset by increases in other areas, most notably in Outputs from Non-Government Output Suppliers; and Net Surplus of Statutory Authorities and Government Owned Companies.

Outputs from Non-Government Output Suppliers is forecast to increase by $1.5 million, mainly due to increased costs for the provision of overseas medical care to qualified persons who have exceeded their health insurance benefits or who have no health insurance.

The Net Surplus of Statutory Authorities and Government Owned Companies (SAGCs) is forecast to be $3.7 million. This is approximately $1.3 million less than the $5.0 million surplus projected in the budget and can be directly attributed to the delayed implementation of new legislation which provides a new revenue stream for the Cayman Islands Monetary Authority (CIMA).

However, I am happy to report that this legislation was approved by the Legislative Assembly during our April 2014 meeting and will shortly come into force allowing CIMA to collect the additional revenue.

Cash flow during the first half of fiscal year 2013/14 was positively impacted by the $10.0 million received from Statutory Authorities as part of the Entire Public Sector Cash Management initiative where SAGCs placed surplus cash on deposit with the Treasury. This initiative significantly reduced the Core Government's use of the bank overdraft facility allowing the Government to save approximately $86,000 in external financing costs after paying interests to the SAGCs.

In addition, SAGCs were **encouraged** to work with each other to facilitate foreign exchange transactions and reduce any potential losses from the buying and selling of foreign exchange via commercial banks.

At the end of April 2014 this had resulted in approximately $54,250 in savings on foreign exchange transaction costs thereby highlighting the need for greater collaboration between SAGCs or the introduction of legislative provisions if necessary.

These are two examples of how the Government has improved efficiency of its cash management operations resulting in lower expenditures. We will continue with these initiatives in 2014/15 and seek further innovative ways to improve the expenditure savings.

As a result of the increased revenues and reduced operating expenditure, the 2013/14 closing cash balance is $173.6 million, $11.6 million more than the $162.0 million forecasted in the approved 2013/14 budget.

Mr. Speaker, overall the Government has prudently managed its finances in 2013/14 and is on track to exceed its budget targets for FFR compliance. For 2014/15 we will build on this positive momentum as we push forward in our journey to achieving full FFR compliance by 30 June 2016.

ECONOMIC OUTLOOK

World Economy

In its April 2014 World Economic Outlook, the International Monetary Fund has reported that the global economy is improving. Global demand improved in the second half of 2013, which increased global output by 3.0 percent, slightly lower than the 3.2 percent recorded in the preceding year. The advanced economies expanded by 1.3 percent, slightly weaker than the 1.4 percent growth recorded in 2012 while emerging and developing countries recorded a 4.7 percent growth, slightly lower than the 5.0% growth recorded in 2012.

Global economic output is expected to strengthen to 3.6 percent in 2014 with the advanced economies, the main markets for Cayman's financial and tourism services, also projected to turn in higher economic performance, growing at 2.2 percent in 2014.

The Cayman Islands' Economic Performance and Forecasts for 2014/15

Output (GDP) Growth - During 2013, economic output increased by 1.2 percent as compared to 1.4 percent recorded in 2012 and 0.9 percent in 2011. Growth in 2013 was generated largely by the service sectors led by 1) hotels and restaurants, 2) transport, storage and communication, 3) real estate, renting and business activities, and 4) financing and insurance.

Strong growth of 7.4% in stay-over tourism boosted the performance of the hotels and restaurants sector by 6.6% as well as transportation, storage and communication sectors which grew by 2.4%. The latter was also facilitated by a higher volume of cargo transportation despite a reduction in cruise transport. Also, an expansion in the broadband market supported marginal growth in telecommunication activities.

The Financing and Insurance services sector, which accounts for the largest share of GDP, is estimated to have expanded by 1.7 percent in 2013 compared to 2.0 percent in 2012. Value added from insurance services rose by 7.5 percent in 2013 as the increase in gross premiums outweighed net claims. For the same period, higher interest income indicated modest growth in the local banking sector.

Value added in the Real estate, renting and business activities sector is estimated to have increased by 1.3 percent, as both business services and real estate activities were enhanced by higher registration of companies and property transfers during the year.

However, some sectors declined in 2013. Value added for Government services contracted by 1.5 percent due mainly to the combined effects of lower staff levels and reduction in capital expenditure.

Wholesale and retail trade activity also declined by 2.1 percent as indicated by the imports of non-oil related goods after adjusting for inflation.

Therefore, based on the economic performance of 2013 and the forecast for 2014, GDP growth for the FY 2014/15 is estimated at 2.0 percent.

Inflation - In 2013, consumer prices rose on average by 2.2 percent, as compared to 1.2 percent in the preceding year. All major categories in the CPI basket had higher inflation rates except for housing, utilities, recreation and culture.

The forecast inflation rate for FY 2014/15 is 2.0 percent based on projected higher global prices of non-oil commodities, and a marginally higher inflation forecast for the USA, our largest trading partner.

Employment - In 2013, a smaller population and a lower labour force participation rate led to a decline in the labour force by 0.8 percent to settle at 38,483.

The total number of persons employed declined by 0.9 percent to 36,070 persons, due mainly to the 6.7 percent reduction in non-Caymanian employment as the number of Caymanians employed improved by 6.1 percent. The overall unemployment rate deteriorated modestly to 6.3 percent. The unemployment rate for Caymanians in October 2013 fell to 9.4 percent from 10.5 percent in 2012.

In 2014, the overall unemployment rate is forecast to fall slightly to 6.1 percent. Consequently, the forecasted unemployment rate for FY 2014/15 is placed at 6.0 percent, an improvement from 6.2 percent for FY 2013/14.

To improve the frequency of unemployment statistics the Government has budgeted for two labour force surveys in each fiscal year commencing in October 2014.

Current Account - In 2013, merchandise imports rose to $774.5 million, 2.1 percent higher compared to a year earlier. The growth was largely a result of the higher value of fuel imports and non-oil consumer goods.

The country's current account deficit was estimated to have narrowed by 1.3 percent to $479.5 million, or 18.0 percent of GDP in 2013 due mainly to an increase in the inflow of funds arising from higher visitor expenditure and business services.

In 2013, estimated inflows from visitor expenditures dominated the inflow of funds. This was estimated at $409.7 million, higher by 2.4 percent from a year earlier due to strong growth in air arrivals despite a slump in cruise arrivals. Meanwhile, receipts from financial services were estimated at $405.7 million, an increase of 1.8 percent as new company registrations rebounded from the decline a year earlier. Also, workers remittances abroad were marginally lower as foreign employment decreased.

In FY 2014/15, higher projected imports and remittances are estimated to outweigh tourism and financial services receipts from abroad. Nonetheless, the current account deficit is not expected to exceed 17.9 percent of GDP due to economic expansion.

ECONOMIC TOOLS

Mr. Speaker, a country's ability to influence the level of economic activity nationally is directly related to the number of economic tools it has at its disposal. The difficulty for Cayman is that, unlike many other economies that employ a combination of monetary policy and fiscal policy to stimulate and influence economic activity, successive Caymanian Governments' economic policy has been limited to fiscal policy only.

This is limited even further with indirect taxation only, by which to influence or stimulate economic activity, employment, and Government revenues. In addition, the FFR further restricts any fiscal policy actions we may wish to take as the FFR specifically limits our expenditure and ability to borrow.

Consequently, we rely on a system of indirect taxes for revenue which is derived from a myriad of coercive revenue measures, of which financial services fees, import duties and work permit fees account for the vast majority of the indirect tax revenue.

Our country's economic policy has always been to encourage growth and development in order to provide employment and generate the level of economic activity necessary to meet the ever increasing demand for revenue by successive Government administrations. This may be attributed to the impact of our international obligations and market forces within the domestic economy as well as the social and economic policies of successive Government administrations.

Whether our Government expenditure is financed by taxes or borrowing, what really matters is the size of Government as this ultimately affects how much of our country's resources are reallocated to the Public Sector.

How efficiently this is carried out will always be the question for debate. However, our goal ought to be that we control Government expenditure so that it grows at a slower rate than the overall economy for any given period. This is the only way of avoiding the risk of increased taxation or deficit spending financed by borrowing.

In other words, the projected rate of growth for nominal GDP should always exceed the rate of growth for Government expenditure for any given period. Overtime, the relative size of Government to the economy will decline, allowing for Private Sector growth and greater efficiency in the allocation of resources and employment of the factors of production by the private sector instead of the public sector. This approach, if adopted by successive Governments should have several advantages over the fixation on balanced budgets or debt balances.

The advantages are as follows:

1. It focuses on the problem of excessive Government rather than the symptom of higher taxes, bureaucracy or deficit spending;
2. Government has the power to control the growth of its spending through privatizations and implementation of policies. The current approach of surplus budget requirements puts Government at the mercy of international economic forces, causing large and unpredictable fluctuations in tax revenue; and
3. Spending can still grow at the rate of inflation, even in an economic downturn and therefore, more politically sustainable.

Economic Stimulus Measures

Mr. Speaker, the size of our population, geographic location and economic structure contribute towards the cost of doing business and living in our beloved Cayman Islands. This Government is acutely aware of the financial pressures placed on everyone and we are working on sustainable solutions to help reduce these costs while also bolstering our economic viability.

The prolonged challenges that the Cayman economy faced over the past several years, particularly in the labour market, placed severe strains on our citizens and residents alike. The unemployment rate increased from 4.0 percent in 2008 and was last measured at 6.3 percent in 2013. The proportion of employed persons in the middle-income brackets (those earning between $28,800 to $86,388) declined from 44.3 percent in 2008 to 40.2 percent in 2013. At the same time, those earning below this bracket increased in proportion from 44.6 percent to 47.3 percent.

These trends can be directly associated with the slow recovery of the economy: GDP growth has not been strong enough to jump-start a recovery in the labor market for a greater number of jobs and improvement in earnings. Consequently, the middle class has shrunk, dampening the growth of domestic demand and curtailing the ability of the economy to expand at a more robust pace.

However, Government actions alone cannot fully solve this problem as the structure of the Cayman Islands economy limits the tools that are available to the Government to intervene in the economy. For instance, we do not have a Central Bank which controls interest rates, foreign currency exchange rates or the levels of liquidity and capital in domestic financial markets. In addition, as stated earlier, the Government's fiscal policy options are limited by the FFR as we are unable to stimulate the economy with deficit budgets financed through borrowings as employed elsewhere during times of slow economic growth.

Mr. Speaker, I do not want to be misunderstood for one moment, as I am not recommending that we seek to implement such institutions, I am just highlighting that we do not have the sophisticated economic management tools available in developed countries.

In order to address the cost of doing business and living it is necessary that all entities within our economy play their part, from the individual to the large corporations. Choosing to purchase goods and services available locally influences the health and strength of our economy and in turn creates opportunities for all categories of businesses, including small businesses, to grow and flourish.

It is internationally known and accepted that small businesses are the core of an economy. The small business sector is the hotbed of creativity, innovation and new product development.

The Economics and Statistics Office reports that here in Cayman during 2013: small businesses provided the largest share of employment, by employing 14,660 persons or 40.6% of our workforce. By comparison, medium sized businesses with 11 – 49 employees provide 28.1 % of employment and large businesses with 50 or more employees provide 30.5% of employment. Clearly, the small business sector is a major contributor to our economy and their continued viability benefits us all.

Mr. Speaker, contrary to complaints by residents and visitors alike, the World Bank has determined that with respect to the general price level and consumption expenditure, the Cayman Islands is not the worst place in the world. In fact the cost of living in Cayman is lower than that of the U.S.A., Canada, the UK and most others European Union member states, the Bahamas, Barbados, Bermuda, the TCI, BVI, Switzerland and Australia just to name a few.

Nonetheless, the Government is mindful that fiscal policy must address this situation. There is a need for the Government to improve purchasing power of the low and middle income classes within our society by reducing their tax burden. As their tax burden is reduced, their disposable income is expected to increase which will in turn generate greater demand for goods and services in the domestic economy. Therefore, as domestic demand improves, jobs and earnings will hopefully improve to regrow the middle class.

The recovery of the middle class is essential in sustaining higher GDP growth over the medium-term as it is predicted that the propensity of persons in this income class to consume goods and services can be sharply higher than persons in the higher income classes.

Consequently, I am pleased to announce that the Government will be implementing the following suite of economic measures which are designed to lower the cost of doing business and living here in the Cayman Islands:

1. **Reduced Import Duty on Diesel Fuel used by CUC to generate electricity;**
2. **Reduced Import Duty for Licensed Traders;**
3. **Reduced Trade and Business License Fees for Small Business Licensees; and**
4. **Continuation of Current Incentives for the Sister Islands.**

1. Reduced Import Duty on Diesel – Effective 1 January 2015, the Government will reduce the import duty charged on diesel imported by Caribbean Utilities Company Limited (CUC) for the generation of electricity from 75 cents per imperial gallon to 50 cents per imperial gallon.

With this measure the Government is projecting that the average customer, both residential and commercial, will see their bills reduced by approximately 4.3%. This projection assumes that the price of fuel and CUC's fuel consumption and efficiency is similar to current levels.

Currently, the import duty on fuel accounts for approximately 13% of the average customer's electricity bills. This measure reduces that proportion down to approximately 8.3%.

Mr. Speaker, this measure provides essential financial relief to all consumers of electricity in Grand Cayman, both residential and commercial, and frees up "real cash" allowing for the opportunity to save that cash or spend it in other areas more beneficial to the wider economy.

The Government will be foregoing approximately $8.4 million annually in reduced revenue by implementing this measure, but we believe that the benefits to the Cayman economy far outweigh the financial loss to the Government.

The Government will be closely monitoring the effectiveness of this measure to ensure that CUC is passing the savings on to consumers and that commercial customers in particular are in turn passing these savings on to their consumers.

2. Reduced Import Duty Rates on Merchandise – Effective 1 July 2014, for licensed traders only, the Government will reduce import duty rates on items currently charged at 22% down to a 20% rate. The items falling into this category includes most items offered for retail sale and will result in the Government collecting at least $4 million less in revenues from import duty. However, again the economic impact of this measure is expected to outweigh any financial loss to the Government because of the multiplier effect.

By reducing the above mentioned import duty rates, we are lowering the cost of doing business and expect that retailers and service providers will be able to pass these savings on to their customers, thereby lowering the cost of living and increasing aggregate output through demand for goods and services.

On a related note, the Government will also be completely removing the import duty on critical ingredients for local bakeries such as: yeast; shortening and calcium propionate. This will improve the financial competitiveness of this sector by lowering overheads and allowing local producers to price their bakery products more competitively.

With respect to building materials, the Government will also continue to offer the import duty concession on building materials which are currently being charged import duty at the rate of 15% versus the normal range of 17% to 22%. This will continue to act as an incentive for the construction sector.

3. Reduced Trade and Business License Fees – Effective 1 July 2014 the Government will be implementing a series of changes to Trade and Business License Fees.

As an incentive to support the creation and development of new businesses, the Government will offer the following discounts to small businesses based on their location:

- George Town and West Bay – 25% discount;
- Bodden Town/ North Side/ East End / Little Cayman – 50%; and
- Cayman Brac – 75%

Small Businesses – i.e. those with 10 or fewer employees, will be permitted to pay their annual License fee in quarterly installments instead of the typical one-time full payment. We recognize that in the current economic climate the requirement of a one-time full payment is onerous since the annual payment is required during the period when cash flows are at their lowest.

4. Continuation of Current Incentives for the Sister Islands

The Government will continue the following economic incentives for the Sister Islands:

- 100% import duty waiver on building materials imported to Cayman Brac and Little Cayman;
- 100% import duty waiver on diesel fuel for Cayman Brac Power and Light;
- 12.5 cents per gallon import duty rate (or a duty rate waiver of 83.3 per cent) on the importation of motor gasoline to Cayman Brac; and
- 100% waiver on stamp duty for the purchase of land in Cayman Brac, providing it is developed within two years.

Recent Changes in the Customs Tariff Law

Mr. Speaker, I will take a few moments to speak to this matter as Customs import duties are a very significant contributor to Government revenues. Also, relevant and timely data on imports provide valuable information for Government analysis and policy development as well as business planning in the private sector.

The Customs Tariff Law (2012 Revision), which encompassed the Harmonized System, was passed in the Legislative Assembly on 5th April 2012 under the United Democratic Party's administration but only came into force on 1 March 2014.

Although the Law was passed in the Legislative Assembly, on 5th April 2012, the Law did not actually come into force at that time as the Customs Department required additional time to implement the Total Revenue Integrated Processing System or TRIPS computer system – which is specifically designed to accommodate the 5,000 tariff codes of the Harmonized System.

The tariff codes in the previous version of the Customs Tariff Law were vague and made it increasingly challenging for the Government to calculate the amount of revenue raised or lost when policy decisions were made to increase or decrease import duties on specific goods.

To address these financial and statistical limitations, the Government decided to adopt the Harmonized Commodity Description and Coding System which is also referred to as the Harmonised System.

Therefore, the Customs Tariff Law (2012 Revision) formally came into force on 1st March 2014, following the successful implementation of TRIPS.

Mr. Speaker amendment to the law on 5 April 2012 also removed the duty free allowance for both churches and schools, making their imports dutiable under the relevant tariff codes. Nevertheless, Mr. Speaker, I have been exercising my discretionary powers under the Customs Law to waive duty for schools and churches based on the merits of each application.

Changes made by the People's Progressive Movement Administration

Mr. Speaker, in February 2014, as part of our strategy to reduce the cost of living the PPM administration made the following amendments to the Customs tariffs:

1. School supplies and uniforms were made duty free;
2. The duty free status of reference books used by professionals was replaced with a duty rate of 22%;
3. Electric motorcycles and electric segways were given a duty rate of 10% – the same rate for electric cars; and
4. 15% import duty rate on hybrid motorcycles – the same rate for hybrid cars.

Advantages of the New Customs Tariff Law

The Harmonized System is a tariff nomenclature of internationally standardized names and codes for the classification of traded products and commodities.

The Harmonized System is developed and maintained by the World Customs Organization which is an independent inter-Governmental organization with over 170 member countries.

The Harmonized System comprises 5,000 commodity groups and is organized into 21 sections and 96 chapters, accompanied with general rules of interpretation and explanatory notes. The system begins by assigning goods to categories of crude and natural products and from there proceeds to categories with increasing complexity. The codes with the broadest coverage are the first four digits, and are referred to as the heading. The Harmonized System therefore sets forth all the international nomenclature through the 6-digit level and, where needed, contains added subdivisions of 2 more digits, for a total 8 digit tariff-rate.

The system is used by more than 250 countries as a basis for their Customs tariffs and for the collection of international trade statistics.

It is commonly used for monitoring controlled goods, transport statistics, price monitoring, quota controls, compilation of national accounts, and economic research and analysis.

Adopting the Harmonized System brings many advantages to the Cayman Islands Government and the private sector. The advantages to the Government are as follows:

1. Keeping abreast with the latest internationally-accepted nomenclature in classification of goods;
2. Assisting in making better informed economic analysis and decisions;
3. Facilitating better fiscal policies for subsidies and concessions, etc;
4. Facilitating more efficient forecasting and collection of revenue;
5. Facilitating the comparison of trade statistics with other countries; and
6. Providing better national statistics.

The benefits to traders, brokers and the general public include:

1. Once stakeholders are familiar, faster and more efficient processing of cargo;
2. Proper classification of products and commodities (saving money and time);
3. Harmonized commodity inventory (for better inventory control);
4. Provision of industry analysis statistics (allowing investors and/or businesses to improve market share); and
5. Identification of market trends.

In order to help the public acquaint themselves with the Harmonized System and the tariff codes, the Customs Department has implemented the following measures:

1. A series of familiarization workshops called “Completing Customs Import Entry Forms Correctly” which helps the public with completing their declaration forms;
2. Providing computer access at the Customs Headquarters so that the public can search for the correct tariff codes and commodity descriptions;
3. Updated the Customs website (www.customs.gov.ky) with a link to the tariff codes so that the public may have direct access to the tariff codes;

4. A “Pre-Screening” process where customers’ declaration forms can be checked by Customs while they are waiting in line to ensure that forms and completed accurately and that the proper supporting documents are attached; and
5. In July 2014, introduce an online declaration portal which will allow the public to process and pay their declarations online so that importers are only required to visit Customs to collect their goods.

2014/2015 FINANCIAL FORECASTS

Turning now to the details of the financial forecasts included in the 2014/15 Budget. Total Operating Revenues are forecast to be $657.7 million; Operating Expenditures are forecast to be $508.3 million; and Financing Expenses are forecast at $28.5 million. This results in a core Government net operating surplus of $120.9 million. After factoring in the forecast net operating surplus of the Statutory Authorities and Government Owned Companies of $7.1 million the Entire Public Sector is forecast to record a net operating surplus of $128.0 million. This surplus is $19.9 million higher than the forecasted surplus for the 2013/14 financial year.

The 2014/15 net operating cash flows are forecast to be $152.2 million which will be used to fund Capital Expenditure and Equity Investments of $44.3 million; make principal debt repayments of $25.4 million and increase our cash reserves by a further $82.5 million, which is in line with our plan to achieve FFR compliance in the 2015/16 fiscal year.

At 30 June 2015, our cash balances are expected to be $256.1 million of which $129.9 million will be in the Operating bank account and $126.2 million in seven reserve funds. The balances of the reserve funds at 30 June 2015 are forecast to be:

- General Reserve Fund $58.7 million;
- Environmental Protection Fund $50.9 million;
- National Disaster Fund $4.7 million;
- Infrastructure Development Fund $2.2 million;
- Housing Guarantee Reserve Fund $2.2 million;
- Student Loan Reserve Fund $1.9 million; and
- Sinking Fund $5.6 million – The purpose of this fund is to put aside cash which will be used to make payments on debts as they mature in the future. The fund will be under the control of Her Excellency the Governor and the Minister for Finance and Economic Development, and the Government will deposit $4.3 million during 2014/15 into this sinking fund.

Core Government debt is forecast to be $523.5 million at 30 June 2015 based on no new long term borrowings and principal debt repayments of $25.4 million during 2014/15.

Revenues

We have not sought to introduce any new revenue measures in this budget as to do so would unnecessarily burden the economy at a time when our economic prospects are improving. Consequently, the revenue forecasts took into consideration actual performance of the current year along with projections for growth in GDP, the impact of economic incentives and Government policies as well as specific market forecasts. The 2014/15 forecast operating revenue of $657. 7 million represents a very conservative 0.87% growth rate over the forecast results for the current 2013/14 financial year.

Operating Expenditures

Our efforts to achieve credible and sustainable reductions to operating expenditures has been challenging given the enormous demands placed on the Government to provide funding for the needs of our people, critical services such as education, policing and medical services along with the infrastructure necessary to support economic and social development.

Nevertheless, all Government Agencies are being pushed to reduce their operational costs and improve productivity and efficiency. The mantra: "do more with less" is not just something we hope to do, it is something we must do and I am pleased to report that we are doing so.

You would have seen recently in the press that the Government has recently launched Phase 5 of the Public Sector Reviews – Rationalization Project and commissioned Ernst and Young (EY) to prepare a detailed report recommending which Government agencies or services can be merged, disbanded or privatized.

The Report will also provide an implementation strategy to achieve the recommendations because this is what has been missing from the past Reports on various Public Sector Reform issues.

The outcome of the EY review will give the Government several options to which we are committed to reviewing and making decisions about how best to restructure Government operations. These decisions are complex and we will have to give due consideration to maintaining stability and the likely economic and social impact on society in fiscal year 2014/15. While cost reduction across the public sector is one of the desired goals it cannot be the only goal otherwise we risk absolute failure on many fronts. Decisions made during this process will also have an impact on the 2014/15 financial year and beyond.

In addition to the EY report, the Government will soon receive the report from the Committee established to review the Public Management and Finance Law. The outcome of this review will likely include recommendations for the restructuring of some of the financial management functions and processes of the public sector, potentially reducing the cost of financial management across the Government in future financial years.

The Committee is expected to produce its report by 31 May 2014. Key amongst the recommendations that I expect to find in the Committee's report is one which supports Government transitioning to multi-year budgeting, planned for 1st of January 2016. Multi-year budgeting involves the Legislative Assembly, in the future, approving at one meeting of the House, budgets for periods greater than the present one-year period. Other jurisdictions of similar size to the Cayman Islands, such as Jersey, have practiced multi-year budgeting quite successfully.

For the 2014/15 Budget the Government concentrated its efforts on maintaining capacity and effectiveness across the breadth of services while eliminating one-off, non-recurring expenditure as well as maintaining the expenditure reductions that were made as part of the 2013/14 Budget process.

Mr. Speaker, the Government will continue with a number of expenditure control measures implemented in 2013/14 including:

- The continuation of the Budget Delivery Committee which provides oversight of year-to-date financial performance against budget and makes recommendations to the Minister for Finance;
- Increasing the occupancy of the new Government Administration Building by bringing in agencies where possible thereby reducing rental expenditure. By September 2014 the Portfolio of Legal Affairs will move into the building and give up their leased accommodations;

- Providing more efficient social programmes through strengthening qualification criteria and improving the monitoring of recipients of Government funds; and

- Improved cash management between Core Government and SAGCs by having SAGCs deposit surplus cash with the Treasury during the first six months of the financial year when Core Government's cash inflows are less than Cash Outflows. This avoids the need for Government to seek expensive overdraft facilities and also allows the SAGCs to put their surplus cash to productive use within the public sector.

Mr. Speaker, SAGCs are an integral part of the Cayman Islands Public Sector because they exist through delegated authority to carry out certain functions and to minimize risks. But as a result of the parent and subsidiary structure they are in a position to have first call on the revenue they collect and are not subject to the same direct expenditure controls as core Government Agencies.

Therefore, during the 2014/15 financial year the Government will seek to pass a Public Authorities Bill which will bring uniformity to the governance and accountability arrangements of our SAGCs, particularly from a financial management perspective. The financial performance goals of the Government must, and do, include the SAGCs since the net operating position of SAGCs can increase or decrease the Core Government's net position.

Mr. Speaker, the 2014/15 forecast for Core Government Operating Expenses of $508.3 million (which excludes financing costs of $28.5 million on past borrowings) represents an $8.7 million reduction from 2013/14 forecast expenditure levels. The major components of the forecast operating expenses are:

- **Personnel Costs** – are budgeted at $241.7 million in 2014/15. This represents a $7.4 million increase over the 2013/14 forecast for this category of expenditure and is driven by the need for the Government to fill critical vacancies in safety and security services such as: Customs, Fire, Immigration, Police and Prisons. That said, the Government will continue in 2014/15 with the centralised approach to managing recruitment for expenditure control within this category. Included within the Personnel Costs budget is $11.4 million which will be paid into the Public Service Pensions Fund towards the Government's past service liability for civil service and parliamentarian pensions benefits. It should be noted that the $11.4 million is in addition to the pension contributions made by the Government to the Public Service Pensions Fund each month.

- **Supplies and Consumables** are budgeted to be $87.7 million in 2014/15 which is $3.3 million below the $91 million forecast for this category in 2013/14. For 2014/15 we have achieved savings in this category by: reducing the number of leased premises; reducing professional fees for external consultants; and making smarter decisions about how we consume resources.

- **Outputs from Statutory Authorities and Government Companies** are budgeted to be $94.1 million in 2014/15 which is $6.6 million less than the $100.7 million forecast for 2013/14. This improvement is related to a change in the funding model for the National Roads Authority and the Cayman Islands Monetary Authority where Government has reassigned elements of coercive revenue to these Authorities.

Despite doing so for the purpose of compliance with the FFR requirements this strategy creates a direct link to the revenues generated from the services of these Authorities and improves financial independence and accountability, and allows the Government to reduce its output expenditure with respect to these Authorities.

- **Outputs from Non-Governmental Output Suppliers** are budgeted to be $22.7 million in 2014/15. This is $4 million less than the $26.7 million forecast for 2013/14. The appropriations within this category of expenditure, fund a wide variety of programmes provided by agencies external to the Government.

  The major items in this category are: $11.4 million to fund overseas medical care for indigents and uninsured persons; $2.5 million to provide Legal Aid services to qualified persons; $1.6 million to provide rental housing accommodations to persons in need; $1.5 million in funding to the Cayman Islands Private Schools Association; and $1.4 million of funding to the NCVO Pines Retirement Home to provide residential care to elderly and disabled persons.

- **Transfer Payments** are budgeted to be $31.3 million in 2014/15. This is approximately $1.6 million less than the 2013/14 forecast of $32.9 million for this category of expenditure. The appropriations within this category provide funding for many important programmes including: $11.4 million for local and overseas scholarships; $7.8 million for poor relief payments to the most vulnerable persons in our community; and $6.2 million in benefit payments to our seamen and veterans;

- **Financing Expenses** are budgeted to be $28.5 million in 2014/15 which is $2.1 million less than the 2013/14 forecast. This reduction reflects: no new borrowings; the reducing balance of public debt; reduced interest rates on a portion of the public debt portfolio following refinancing negotiations in December 2013; and the removal of the overdraft facility to finance Government's operations.

- **Depreciation** is budgeted to be $26.8 million 2014/15. Deprecation is a non-cash expenditure which spreads the cost of a capital asset over the expected life of the asset.

Capital Investments

Moving now to Capital Investments, for 2014/15 the Government intends to make investments totalling $47 million, of which $26.7 million will be invested in core Government assets such as:

- $6.2 million for the Ministry of Education for the completion of the multipurpose hall and ancillary infrastructure at the John Gray High School in George Town; and upgrades at other schools;
- $5.0 million for upgrades to various roads on Grand Cayman;
- $4.7 million to the Ministry of Health to fund upgrades to the George Town landfill and solid waste management systems;
- $2.3 million to the Ministry of Home Affairs to fund the purchase of additional security and safety equipment and vehicles for the Fire, Police and Prisons Departments;
- $1.7 million to the Ministry of Financial Services to fund upgrades to their Information Technology infrastructure to meet international reporting requirements for the automatic exchange of information for tax purposes; and
- $1.2 million for the construction and upgrade of roads on Cayman Brac and Little Cayman.

A total of $20.3 million will be invested in SAGCs to fund debt service obligations; operational losses and acquisition of equipment. The major investments in this category are:

- $9.5 million to the Cayman Turtle Farm (1983) Limited to fund debt servicing and operational losses;
- $4.85 million to Cayman Airways Limited to fund debt servicing, capital expenditure and operating losses;
- $2.4 million to the National Housing Development Trust to fund debt servicing obligations; and
- $1.5 million to the Cayman Islands Development Bank to fund debt servicing obligations.

Cash and Debt Management

A major component of the Government's fiscal strategy towards achieving FFR compliance is the strict management of cash and the proactive management of our debt portfolio.

During 2014/15 total cash balances are expected to grow by $82.5 million, reaching $256.1 million at 30 June 2015. This build-up of cash is critical to achieving FFR compliance but it also creates a higher degree of financial resilience for the Government. This is important as it will allow the Government greater flexibility in the future to respond to any crises which may arise.

The Government is not planning to undertake any new borrowings during the 2014/15 financial year. And as at the 1 July 2014 the, Core Government Debt is expected to be $548.9 million. During 2014/15 the Government will make principal payments of $25.4 million, thereby reducing the outstanding debt to $523.5 million by 30 June 2015.

Mr. Speaker, the expected greater opening operating bank account balance at the start of the 2014/15 fiscal year and continued cohesive public sector cash management practices are the principle reasons that led the Government to not request an overdraft facility for the upcoming fiscal year.

This points to Government's renewed confidence in its cash management abilities and the decision will also eliminate overdraft interest expense.

The Government has received representations from the FCO that if there is a request for an overdraft facility to assist the Islands in the event of a natural disaster, such a request would be favourably considered.

In addition to making the scheduled debt repayments, the Government will establish a dedicated sinking fund for debt retirement. This fund will be under the control of Her Excellency the Governor and the Minister for Finance and Economic Development. The Government will deposit $18.22 million over the next four financial years (2014/15 – 2017/18) starting with $4.3 million in 2014/15. This will ensure that sufficient cash is set aside in advance to fund debt payments in future years without jeopardizing compliance with the FFR ratios.

The Ministry of Finance is also examining options for the possible restructuring of the non-amortizing elements of the Entire Public Sector's debt portfolio into amortizing debt instruments which will spread the principal repayments over a more manageable timeframe.

For the Core Government, our focus is on the US$312 million 2009 Bullet Bond which matures on 24 November 2019.

However, it is important to note that the Government will not pursue any course of action that will be contrary to its existing financing agreements. We are also working with the Cayman Islands Development Bank (CIDB) to develop a strategy to refinance its debt portfolio of five separate bullet bonds totalling $34.7 million. During 2014/15 three of these facilities mature with a combined value of $26.4 million as per the following schedule: $16.6 million on 27 April 2015; $4.8 million on 30 June 2015; and $5.0 million on 30 June 2015.

It is the Government's intention that funds held on reserve by CIDB be used to retire the $5.0 million bond maturing on 30 June 2015.

COMPLIANCE WITH FFR TARGETS

In terms of compliance with the Principles of Responsible Financial Management set out in the Public Management and Finance Law and the Framework For Fiscal Responsibility, the 2014/15 Budget forecasts the following levels of compliance with the principles:

1. **Net Operating Position:** – for 2014/15 this has been achieved with a forecast net operating surplus of $128.0 million which complies with the requirement for the Net Operating position to be positive;

2. **Net Worth:** for 2014/15 Net Worth is forecast at $1.59 billion which complies with the requirement for Net Worth to be positive;

3. **Debt Service: that is, the annual payments related to all public sector borrowing commitments should be no more than 10% of core Government Revenue:** – For 2014/15 this is forecast to be 11.3%, down from 12.1% in 2013/14. Government has a further year, to 30 June 2016, to achieve compliance with the 10% upper limit;

4. **<u>Net Debt: Should be no more than 80% of Core Government Revenue:</u>**– for 2014/15 Net Debt is forecast to be 61.2%, down from 78.4% in 2013/14. Compliance with the ratio has been achieved;

5. **<u>Cash Reserves: Should be no less than 90 days of estimated executive expenses:</u>** For 2014/15 this is forecast to be 43.3 days or $63.7 million. As per the FFR, this ratio is calculated at the point in the fiscal year when the core Government's cash balances are at their lowest. Based on the forecast profile of cash inflows and outflows this is expected to occur at 31 December 2014 when the unrestricted cash balances are expected to be $63.7 million. Therefore, taking the cash balances at 31 December allows for a more robust measure of cash reserves. Again, in accordance with the FFR, Government has a further year, until 31 December 2015, to achieve compliance with this ratio.

CONCLUSION

Mr. Speaker, the 2014/15 Budget was developed taking a fiscally prudent and conservative approach which reaffirms this Government's commitment to firmly put the Cayman Islands on the path to fiscal sustainability; not only for compliance with the mandate of the United Kingdom Government but because we want to ensure that our children and grandchildren inherit a country with a promising future and the resources to make their dreams come true.

Cayman is still a developing country and in order achieve our goals there will have to be some pain and sacrifice. For the Government, the pain comes in what we will not be able to achieve in terms of desired investments and activities within a single term. We must focus only on what we can achieve within a particular timeframe and the methods we employ in getting there.

Mr. Speaker, this Budget meets or exceeds the targets set out in the Strategic Policy Statement that I tabled in this Honourable House on 21 November 2013 and demonstrates that Government finances are on the right track. Our Operating Revenues are higher than our Operating Expenditures, resulting in a healthy operating surplus which we are using to build up our cash reserves; fund our Capital Investment programme; and reduce our debt. This is the right direction and we must stay on this track!

The preparation of the Government's Budget is an enormous undertaking and this year would not have been possible without the hard work and commitment of many and I wish to thank the Honourable Minister for Overseas Territories, Mr. Mark Simmonds of the United Kingdom's Foreign and Commonwealth Office and his team for their swift approval of the 2014/15 Budget. We formally submitted the Budget to the FCO on 19 May 2014 and received approval on the 21 May 2014.

I also wish to thank Her Excellency the Governor; the Honourable Premier; Cabinet Ministers; Official Members of Cabinet; Councillors; Chief Officers and their staff. Also, I especially wish to thank the Financial Secretary, Mr. Kenneth Jefferson and the team within the Ministry of Finance, including: retiring Chief Officer Mrs. Sonia McLaughlin; Acting Chief Officers Mr. Michael Nixon, Ms. Anne Owens and Mr. Ronnie Dunn and the staff of the Budget and Management Unit.

Mr. Speaker, It has been both an honour and a privilege to present this Budget today. I now humbly commend the Appropriation (July 2014 to June 2015) Bill, 2014 to this Honourable House and ask all Members for their support of the Bill.

Thank you Mr. Speaker.