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Legislative Council

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Legislative Council
Panel on Financial Affairs

Minutes of special meeting held on
Friday, 21 February 2002 at 2:30 pm
in the Chamber of the Legislative Council Building

Members present :
Hon Ambrose LAU Hon-chuen, GBS, JP (Chairman)
Hon Henry WU King-cheong, BBS (Deputy Chairman)
Hon James TIEN Pei-chun, GBS, JP
Hon LEE Cheuk-yan
Hon NG Leung-sing, JP
Hon CHAN Kam-lam
Hon SIN Chung-kai
Hon Emily LAU Wai-hing, JP
Hon MA Fung-kwok

Non-Panel members attending :
Hon Cyd HO Sau-lan
Hon Margaret NG
Hon CHAN Yuen-han, JP
Hon LEUNG Yiu-chung
Hon WONG Yung-kan
Hon LI Fung-ying, JP
Hon IP Kwok-him, JP
Hon Audrey EU Yuet-mee, SC, JP

Members absent :
Hon Albert HO Chun-yan
Hon Eric LI Ka-cheung, JP
Dr Hon David LI Kwok-po, GBS, JP
Hon James TO Kun-sun
Hon Bernard CHAN
Dr Hon Philip WONG Yu-hong
Hon Jasper TSANG Yok-sing, JP

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Public officers attending	**:**	Miss Denise YUE, GBS, JP Secretary for the Treasury Mr K Y TANG, JP Government Economist Mr Stanley YING Deputy Secretary for the Treasury Mr Albert LAM Principal Assistant Secretary for the Treasury Mr K Y CHENG Treasury Officer
Clerk in attendance	**:**	Ms Anita SIT Chief Assistant Secretary (1)6
Staff in attendance	**:**	Ms Pauline NG Assistant Secretary General 1 Mr WONG Tin-yau, Anthony Senior Assistant Secretary (1)8

I Report of the Task Force on Review of Public Finances

LC Paper No. CB(1)1129/01-02 - Task Force on Review of Public Finances - Final Report to the Financial Secretary

The Chairman welcomed the Secretary for the Treasury (S for Tsy) and other representatives of the Administration to the meeting. He invited S for Tsy to brief the Panel on the final report (the Report) of the Task Force on Review of Public Finances (Task Force) made to the Financial Secretary (FS). The Report was tabled at the meeting.

2. In her introduction, S for Tsy highlighted that prudent management of public finances was crucial to the stability and prosperity of Hong Kong. Amid the adverse economic situation in recent years, there had been increasing concern in both the local and international communities over the state of Hong Kong's public finances, in particular the nature and magnitude of the fiscal deficits experienced in recent years, as well as the sustainability of the fiscal system in the longer term. In briefing Members on the Report, S for Tsy outlined the budgetary trends in the past 10 years, the Task Force's analyses of the changes and developments in the local economy which had significant effects on

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government revenue and expenditure in the past and might continue to exert their impacts in future. She then explained the budget model used by the Task Force to project the state of government finances up to 2021-22 and the model findings on the long-term sustainability of the fiscal system. Finally, she highlighted the major conclusions reached by the Task Force. The salient points of her briefing were as follows-

(a) Taking the operating and capital accounts together, Hong Kong recorded four years of consolidated fiscal deficits since 1991-92. Expressed as a share of Gross Domestic Product (GDP), the deficit recorded was 0.3% for 1995-96, 1.8% for 1998-99, 0.6% for 2000-01 and an estimated 5.2% for 2001-02.

(b) The Task Force had identified several changes in the economy likely to have affected, or might affect, government revenue and expenditure in a fundamental way. On the revenue side, the changes included-

   (i) the consolidation of the property market;
   (ii) the increasing reliance on investment income from the fiscal reserves as a source of revenue; and
   (iii) the outreach of the Hong Kong economy to the Mainland and elsewhere.

   The changes on the expenditure side included-

   (i) the higher price movements in government expenditure than those in the general economy;
   (ii) the aging of the Hong Kong population; and
   (iii) the conscious counter-cyclical fiscal measures adopted by the Government in recent years in the face of the economic downturn.

(c) The Task Force had used a model to project the state of government finances up to 2021-22. The model had incorporated three sets of parameters - economic, demographic, and revenue and expenditure. Under a medium economic growth scenario, the Government would be facing a consolidated deficit of $42 billion in 2002-03, being 3.4% of GDP. The consolidated deficit would rise to $114 billion by 2011-12 (5.7% of GDP) and to $365 billion (11.2% of GDP) by the end of the projection period in 2021-22.

(d) The Task Force also projected that under a medium economic growth scenario, Hong Kong's estimated substantial fiscal reserve balance of some $369 billion would be fully used up by 2008-09. Thereafter, Hong Kong would go into fiscal debts. The Task Force found that even under a higher economic growth scenario,

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the Government would still go into substantial fiscal deficits year after year. And the accumulated fiscal reserves would still be fully used up in 2008-09.

(e) Having regard to the projections on the future fiscal positions under different economic growth scenarios, the Task Force concluded that continuation of the current revenue and expenditure policies was not an option. The Government needed to tackle the fiscal problem in a serious manner to achieve fiscal sustainability.

(f) On the expenditure side, the Task Force recommended that the first priority was to control the growth of government expenditure. It highlighted that growth of government expenditure in nominal terms should be aligned to the trend nominal growth of the economy. This discipline should be applied in addition to the existing budgetary guideline of aligning the growth of government expenditure in real terms to the trend real growth of the economy.

(g) On the revenue side, the Task Force recommended that the Government should consider the views of the public as well as the recommendations of the Advisory Committee on New Broad-based Taxes, which had been set up to advise on what new broad-based taxes would be suitable for Hong Kong and would release its findings shortly.

Reliability and objectivity of budget model projections

3. Mr LEE Cheuk-yan expressed reservation on the reliability of the projections made by the Task Force on the fiscal positions covering a period of 20 years up to 2021-22. He pointed out that many of the assumptions underlying the projections could easily become invalid over time. Ms CHAN Yuen-han questioned the objectivity of the Report and commented that the Task Force had made a number of assumptions in its review and these assumptions might have been laden with subjective preconceptions. She opined that while the analyses pertaining to the review of the economy were acceptable, the projections and the underlying assumptions should be examined with caution.

4. In response, S for Tsy assured Members that members of the Task Force did not conduct the review with any pre-conceived objectives. To make projections on the fiscal positions in the medium term and long term, it was necessary for the Task Force to adopt certain assumptions. These assumptions, together with the relevant historical data, were spelt out in the Report. She appreciated that there might be different views regarding the assumptions, and the Task Force would be pleased to explain the assumptions in detail in future meetings. She assured Members that objectivity was the primary consideration of the Task Force when conducting the review.

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5. Mr James TIEN observed that according to the Task Force's projections under a medium growth scenario, fiscal reserves would be used up by 2008-09, and a fiscal debt of HK$2,661 billion would be accumulated by 2021-2022. He queried if the projections were realistic, since market conditions were bound to change, especially over a period as long as 20 years. For example, there were signs that the sluggish property market sustained over the past few years was picking up in recent months. He cautioned that unrealistic projections made by the Task Force might cause false alarm to Hong Kong as a whole.

6. Mr James TIEN and Mr LEUNG Yiu-chung referred to the recent messages of the Chief Executive (CE) made to the community that the Administration had great confidence in restoring a fiscal balance in three to five years. They queried whether the continued fiscal deficits and the depletion of the fiscal reserves by 2008-09 as projected by the Task Force were in conflict with CE's messages.

7. In response, S for Tsy stressed that the projections made by the Task Force were based on the assumption that the current revenue and expenditure policies were to continue. She clarified that the Task Force had not taken an overly pessimistic view nor intended to paint a gloomy economic picture for the future. In fact, having taken into account the likely impact arising from changes in the economy in recent years and in the future, the Task Force had assumed under the budget model an annual growth of 4.4% in GDP in nominal terms for the years 2003 to 2006 and 5% for 2007 to 2021. She also confirmed that the Task Force had made in-depth analyses of the direct and indirect incomes generated from the property market between 1991 and 2001. Based on the analyses, it was projected that through the years from 2002 to 2021, the income from land premium would amount to 2% of the GDP.

8. S for Tsy also remarked that the Task Force had made alternative projections on the budgetary position for the hypothetical situation which aimed at restoring a consolidated balance in five years' time, i.e. in 2006-2007. Under the medium economic growth scenario, achieving such an objective would entail the raising of new revenue and/or expenditure cuts averaging $35 billion per annum until 2006-07.

9. As regards the reliability of the model projections, S for Tsy acknowledged that as unforeseen and unpredictable circumstances might arise, a model projecting developments spanning 20 years was necessarily constrained, and that the reliability of the projections would decrease as the time horizon expanded. However, the budget model served as a useful tool to identify directions in assessing fiscal sustainability. The Task Force had made projections on the fiscal positions under different economic growth scenarios. While the projected fiscal positions varied to a certain extent under different scenarios, the projections had pointed to the same broad direction, i.e. there would continue to be fiscal deficits if the current revenue and expenditure policies were to continue.

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10. Mr SIN Chung-kai enquired about the major differences between the estimates for government revenue and expenditure for the next four to five years under the medium range forecast made in the 2001-02 Budget and the projections made by the Task Force for the same period. He also asked whether the differences were attributed to different assumptions for the economy. In response, S for Tsy advised that the major differences were the assumptions on the economic growth for the period. Under the medium range forecast in the 2001-02 Budget, it was estimated that there would be 4% real growth in GDP annually in the medium term, whereas the Task Force had revised this projection to 3%. Secondly, in the 2001 Budget, the projected GDP deflator for the year 2002 was of a positive value, whereas this had been revised to a negative value (-1.5%) in the Report. She said that she would be pleased to discuss in further detail separately about other differences between the medium-term projections made in the 2001-02 Budget and those made by the Task Force.

Implications of the review results on future government expenditure

11. Noting the conclusion of the Task Force that to restore fiscal sustainability over the next few years, the Government should accord priority to controlling the growth of government expenditure, Mr LEE Cheuk-yan expressed concern that exerting stringent control over government expenditure would entail reduction of welfare services and social security assistance for the disadvantaged and vulnerable groups of the community. As such, the economic hardship currently experienced by the disadvantaged and vulnerable would be aggravated in the next few years. Mr LEE opined that instead of cutting public expenditure by reducing services and social security assistance, the Administration should focus its efforts on raising revenue from those who had the financial capacity to contribute more. He in particular suggested that the option of increasing the profits tax rate and/or introducing progressive rates for profits tax should be pursued. Mr LEE also cautioned that the proposal to control public expenditure might be in conflict with the commitments made by CE and FS to create more job opportunities and to enhance the assistance to the disadvantaged groups of our society. Mr LEUNG Yiu-chung echoed the concern of Mr LEE.

12. In response, S for Tsy confirmed that the Task Force considered that decisive actions were needed to restore fiscal sustainability and the Government should accord priority to controlling the growth of public expenditure. However, the Task Force had not recommended to reduce government expenditure as such. The Government could consider different strategies to restore fiscal balance, and a combination of increasing revenue and controlling expenditure growth could be one of the possible strategies. She remarked that it was not within the purview of the Task Force to recommend what fiscal measures should be taken, and that the ultimate decision regarding the best means to restore fiscal sustainability rested with CE and FS.

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13. Ms Cyd HO said that she agreed in principle that if there was no significant improvement in the economic condition, the Administration should increase revenue and reduce expenditure in the coming few years. However, she would urge the Administration to ensure that any measure to reduce public expenditure or raise revenue would not be taken at the expense of the lower-income and the disadvantaged sectors of the society. She also opined that the Task Force's assumptions on the annual GDP growth for the next 20 years were overly optimistic, and urged the Administration to provide more realistic projections for Members' consideration in future.

14. Mr CHAN Kam-lam noted that under the medium economic growth scenario, restoring a consolidated balance in five years' time would entail the raising of new revenue and/or expenditure cuts averaging $35 billion per annum until 2006-07. He said that in the light of the current economic situation, it would be difficult to raise such a high level of additional revenue without causing an adverse impact on the economy. He therefore asked if the Administration had in mind any specific measures to reduce expenditure to balance the budget.

15. S for Tsy clarified that it was not within the purview of the Task Force to develop concrete measures to increase revenue and/or reduce expenditure and balance the budget. Instead, CE and FS would in due course present the Administration's economic plans to the community. The Task Force however had made various observations which it believed would provide useful reference for the Government to develop such measures. For example, the Task Force had observed that Hong Kong was rapidly developing closer economic ties with the Mainland, which offered much potential for boosting Hong Kong's economy in the region. It had also noted that the globalization of business activities was taking up speed, and this development posed new challenges to various economies including Hong Kong.

Fiscal reserves and accumulated surplus in the Exchange Fund

16. Ms Emily LAU said that some LegCo members, including herself, did not support the guideline for the target level of the fiscal reserves announced by the former Financial Secretary, which implied that the lower limit of the target fiscal reserves should be set at roughly 18 months of government expenditure. Miss LAU pointed out that in addition to the current fiscal reserves of HK$369 billion, there was also an accumulated surplus of some HK$300 billion in the Exchange Fund, and this surplus should also be regarded as a reserve at the Government's disposal. Miss LAU stated that given such a formidable size of the reserves (fiscal reserves and the accumulated surplus) of over HK$600 billion, there should be room for using part of the reserves for economic relief measures to benefit the community at this difficult economic time, whilst exercising prudence in the use of public monies. She enquired whether the Task Force had taken into account in its study the availability of the accumulated surplus in the Exchange Fund for disposal by the Government.

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17. S for Tsy replied that the accumulated surplus of the Exchange Fund was not regarded as part of the fiscal reserves. It was a component of the Exchange Fund, the functions of which were stipulated in the relevant legislation. Basically, the Exchange Fund served to maintain the stability and integrity of the monetary and financial systems of Hong Kong. She confirmed that the Task Force had not included the Exchange Fund as a factor affecting the fiscal system in future. In respect of the guideline of maintaining the fiscal reserves at around 18 months of government expenditure established in 1998, S for Tsy advised that since this guideline still prevailed, the Task Force had made projections based on the objective of maintaining the fiscal reserves at this target level. S for Tsy further said that for illustration and comparison purposes, the Task Force had also developed projections on the basis of target levels of 12 months and 18 months of government expenditure.

18. Mr James TIEN asked whether the linked exchange rate system was assumed to be maintained under the Task Force's projections. S for Tsy replied that apart from the parameters spelt out in the report, the Task Force had not incorporated further parameters into the budget model. The linked exchange rate was not one of the parameters included in the model and therefore the Task Force had not assumed any future changes to the system in making its projections.

Prices of government spending versus general price levels

19. Ms Emily LAU, Mr MA Fung-kwok and Miss Cyd HO noted with concern that the cost of government spending had consistently been increasing faster than general price levels in the economy, as revealed by the continued differential price movements in government expenditure (as measured by the Government Consumption Expenditure (GCE) deflator) and those in the general economy (as measured by the GDP deflator). The Members sought elaboration on the reasons for the continued variance between the GCE deflator and the GDP deflator and asked if the Administration had any plans to bring the price movements in government expenditure in line with those of the general economy with a view to reducing/eliminating the fiscal gap arising from the consistently higher prices of government spending.

20. S for Tsy and the Government Economist (GE) explained that since 1986, changes in the GCE deflator had persistently been higher than the GDP deflator. The average value of the difference over this period was about 2%, or 200 basis points. The main reason for the difference was the high wage content of the GCE deflator, since salaries and pensions were the key expenditure items of the Government. Wage-related items accounted for 70% to 80% of the total weighting of the GCE. While there had been upward adjustments in salaries for civil servants and government funded organizations during periods of normal and stable economic growth, the salaries had not been adjusted downward when the economy deflated in recent years. On the other hand, the upward and

downward adjustments in general price levels, which were in turn affected by various trade and economic factors, were fully reflected by the GDP deflator.

21. S for Tsy further said that the difference between the price movements of government expenditure and those in the economy and hence the resultant fiscal gap would persist if the current expenditure policies were to continue. To address the issue, the Task Force had highlighted in its conclusions the need to align the growth of government expenditure with the trend growth of the economy in real terms as well as in nominal terms.

22. The Chairman thanked S for Tsy and the Administration for attending the meeting, and said that further sessions to discuss the Report in greater depth and detail might be arranged, if Members considered it necessary at a later stage.

II Any other business

Proposals of the Hong Kong Society of Accountants to address concerns arising from the Enron case

23. The Chairman said that Miss Emily LAU had requested that the Hong Kong Society of Accountants (HKSA) be invited to brief the Panel on its proposals to address concerns arising from the Enron case. As such proposals might be related to the subject of "Review of listing rules on corporate governance", which had been scheduled to be discussed at the Panel meeting on 4 March 2002, he consulted members on whether HKSA should be invited to join the discussion of the subject or a separate session should be arranged for the discussion with HKSA. Miss Emily LAU suggested and members agreed that a separate session should be arranged for HKSA to brief the Panel on its proposals.

(*Post meeting note:* A special meeting has subsequently be held on 14 March 2002 to discuss the initiatives to strengthen Hong Kong's corporate governance regime. HKSA and other relevant parties had taken part in the discussion.)

Subsidiary legislation to be made for implementation of the Securities and Futures "Ordinance"

24. The Chairman informed the Panel that the scrutiny of the Securities and Futures Bill by the Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000 had been completed. The Administration planned to introduce 39 sets of subsidiary legislation under the Securities and Futures "Ordinance". While there was a standing arrangement for the Administration to consult the relevant Panel on major legislative proposals before formal introduction of the legislation, the Bills Committee had recommended to set up a subcommittee under the House Committee to examine the draft subsidiary legislation. The Bills Committee would report its deliberation, including its

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recommendation to set up a subcommittee, to the House Committee on 22 February 2002. Members agreed that if a subcommittee would be formed to scrutiny the draft subsidiary legislation, there should be no need for the Panel to discuss the draft subsidiary legislation.

25. There being no other business, the meeting ended at 3:45 pm.

Legislative Council Secretariat
22 April 2002