# Executive Summary

1. The fiscal health of Hong Kong is envy to many. Hong Kong would experience ten successive years of budget surplus since 2004-05. Fiscal reserves reach some $750 billion, which is about 21 months of government expenditure or over 30% of the nominal Gross Domestic Product (GDP). With continued economic growth, and with the powerful backing of the Mainland as hinterland for Hong Kong, do we really have a fiscal problem?

2. Appointed by the Financial Secretary, the Working Group on Long-Term Fiscal Planning has completed a fiscal sustainability appraisal on the current state of public finances in Hong Kong. The fiscal sustainability appraisal includes three core components, being projections on –

   (a) economic growth,
   (b) government revenue, and
   (c) government expenditure.

   A balanced and sustainable development requires **all three** components to grow at rates that are commensurate with one another. This is the wisdom enshrined in Article 107 of the Basic Law.

3. In line with its terms of reference, the Working Group has conducted the fiscal sustainability appraisal on the basis of the official population projections up to 2041 and, unless otherwise defined in the different expenditure scenario analyses, assumed that prevailing government policies (including tax, immigration, retirement and welfare policies, etc.) and commitments announced in the 2014 Policy Address would continue throughout the projection period.

## Ageing

4. The population in Hong Kong is ageing fast. This affects GDP growth, government expenditure as well as government revenue.

   (a) In 2012, **total population** in Hong Kong was 7.1 million; this is forecast to **grow by about 19%** to 8.5 million in 2041.

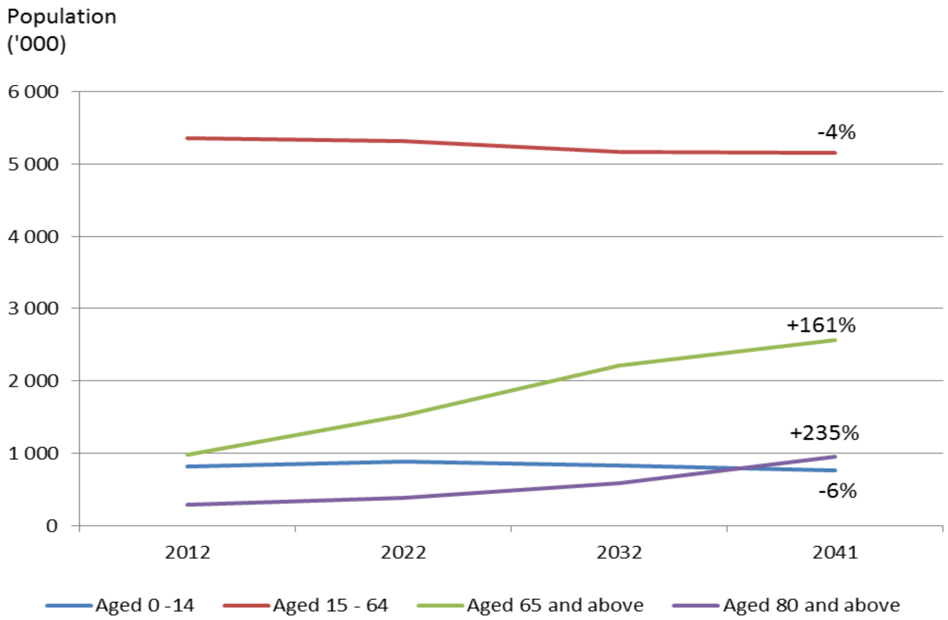
   (b) The age group between **15 and 64** is forecast to **drop 4%**, from 5.3 million to only 5.1 million in 2041.

   (c) By contrast, the age group of **65 and above** is forecast to **grow 161%**, from 980 000 in 2012 to 2 560 000 in 2041. Within this group, those **aged 80 and above** is forecast to **grow 235%**, from 286 000 to 957 000.

   (d) The **elderly dependency ratio** (ratio of those aged 65 and above to those aged 15 to 64) would **increase** from 18.3% in 2012 to **49.7% in 2041**.

   (e) The **median age** for Hong Kong was 42.8 in 2012; it is forecast to be **51.8 by 2041**.

*Population changes by age groups*



5. An expanding and ageing population will put pressure on social welfare and health services expenditure. Purely on account of headcount change, i.e. assuming **no** inflation and **no** service enhancement over time, government expenditure on selected age-sensitive items would multiply –

| **(in 2013 constant prices)** | **2014-15 $ Billion** | **2041-42 $ Billion** |
|---|---|---|
| Recurrent subvention requirement of Hospital Authority | 47.2 | 85.6 |
| Old Age Living Allowance/ Old Age Allowance | 14.6 | 36.4 |
| Welfare services for the elderly | 6.2 | 16.3 |
| Public Transport Fare Concession Scheme | 0.6 | 1.8 |
| Elderly Health Care Voucher Scheme | 0.8 | 2.5 |

With the population ageing, the size of the labour force is set to decline, posing a threat, if not drag, on economic growth and putting pressure on government revenue.

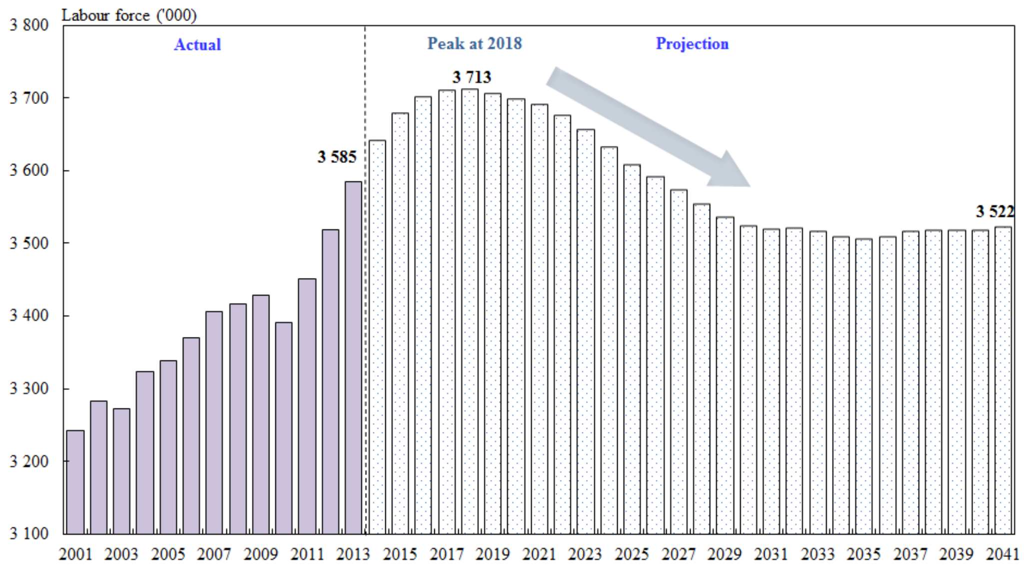
## Economic Growth

6. The fundamental driver that determines how much the Government receives and theoretically restrains how much the Government can spend is the performance of the economy. As a small and open economy, Hong Kong is **highly susceptible to the influences of the global economy**. The oil crisis and stock market crash in the mid-1970s, the global recession in the early 1980s, the Asian financial crisis in 1998, and the IT bubble burst in 2000 coupled with the outbreak of the Severe Acute Respiratory Syndrome (SARS) in Hong Kong in 2003 all coincided with occasional years of budget deficit for Hong Kong in 1973-74 and 1974-75, 1982-83 and 1983-84, 1998-99, and 2000-01 to 2003-04 respectively.

7. Hong Kong's economic growth has steadily decelerated over time, reflecting the evolution from a developing economy marked by high growth to a mature economy with lower growth. GDP growth was **8.9%** per annum in the 1970s, **7.4%** per annum in the 1980s, and **5.0%** per annum in the mid-1990s. Trend growth averaged at **3.4%** per annum in the post-1997 era. For the past 30 years, the trend GDP growth of 4.6% per annum was achieved with the support of 1.3% per annum growth in the labour force, and around 3% labour productivity growth per annum, the latter being driven by an on-going process of structural transformation towards a knowledge-based and high value-added service economy.

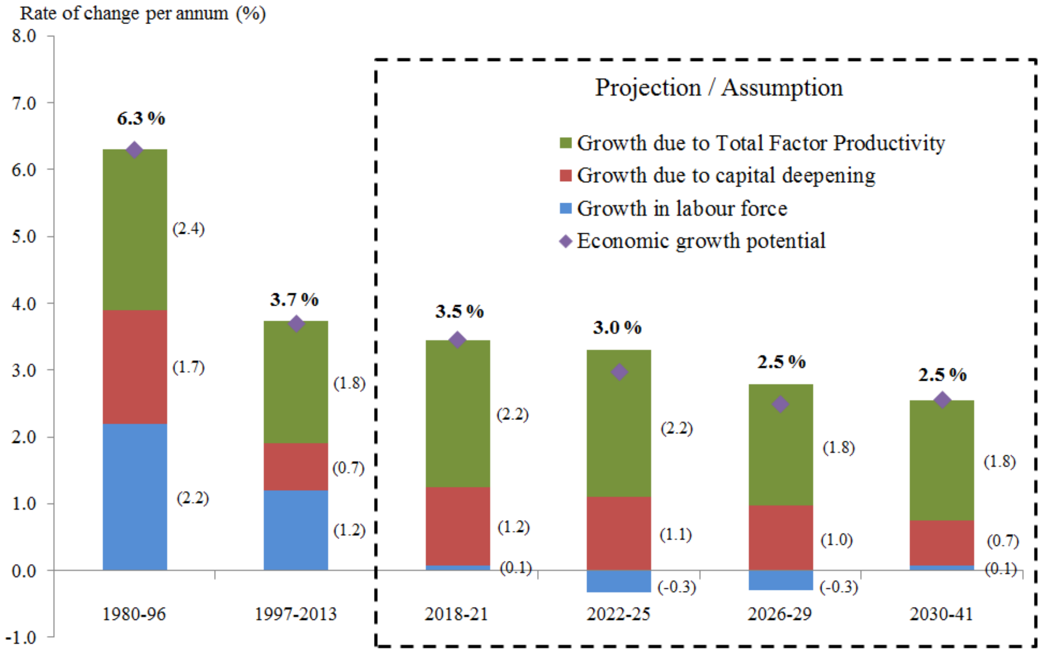
8. Looking ahead, under existing population policies, local labour force is expected to peak by 2018 and gradually decline until the early 2030s. Although productivity growth in our workforce is assumed to keep in pace with the vibrant performance in the past, Hong Kong's long-term growth prospect in the coming three decades will unavoidably be constrained.

*Labour force is expected to decline after 2018, only to stabilise in the 2030s*




Notes : Figure for 2013 is provisional.
The projections from 2014 onwards are based on *Updated Hong Kong Labour Force Projections for 2013 to 2041, Hong Kong Monthly Digest of Statistics, the Census and Statistics Department (C&SD) (September 2013)*.

*Economic growth looks set to decelerate over the long term as labour force starts to stagnate*

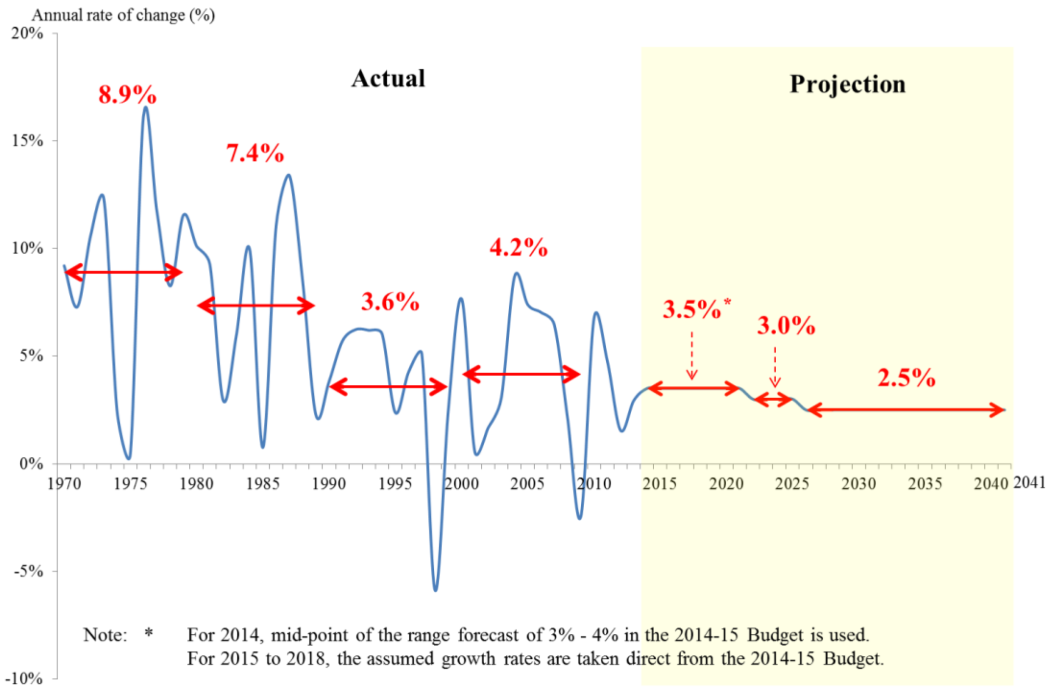



Notes : ( ) Contribution to the economic growth potential in percentage point.

Economic growth potential refers to the **potential output** growth under full employment. As such, the growth rates presented here for 1980-1996 and 1997-2013 differ slightly from the **actual GDP** growth rates. For details, see **Chapter 2** and **Annex B**.

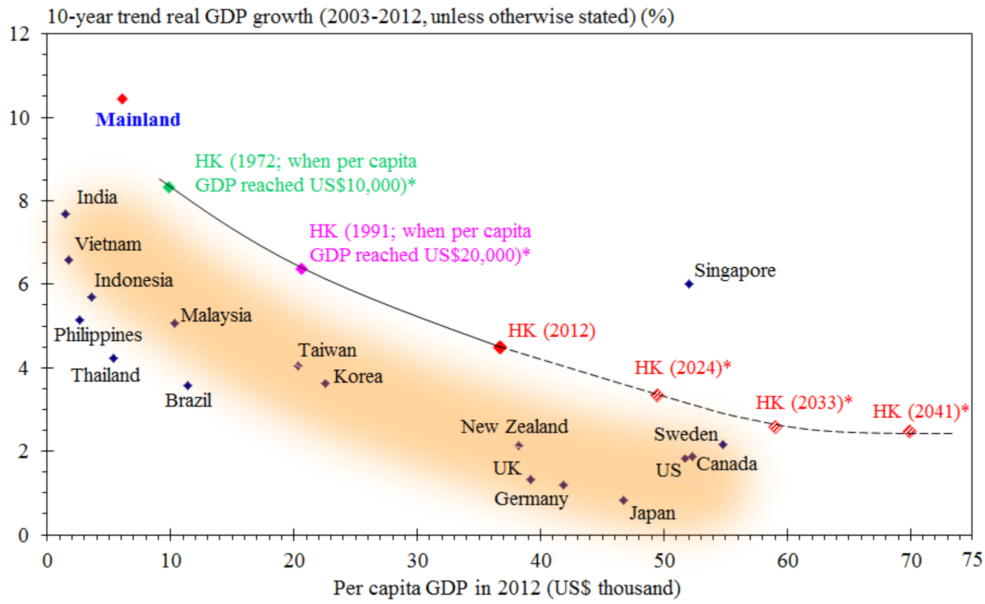
9. The Working Group has adopted a **Base Case** (regarded as the best estimate) that assumes that real GDP growth would stay at **3.5%** per annum from 2014 to 2021 and gradually decelerate to **3%** for 2022 to 2025, and then further to **2.5%** from 2026 to 2041. The macro-economic assumptions for the short to medium term (2014 to 2018) follow those in the 2014-15 Budget and are accepted by the Working Group as given. The Base Case assumptions from 2014 to 2041 imply **an average projected real GDP growth rate of 2.8% per annum**, lower than the historical trend growth rate of 3.4% since 1997-98.

*Real GDP growth*



10. In context, a long-term real GDP trend growth at 2.8% per annum would put Hong Kong amongst the league of **mature economies**. The following chart shows the relative 10-year trend GDP growth of various economies from 2003 to 2012.

*Economic growth bound to go lower as the economy becomes more mature*




Notes: * Per capita GDP figures for these data points are in 2012 constant dollar terms, i.e. they have been adjusted for change in prices over time for more meaningful comparisons. The figures beyond 2013 are projected figures derived from the macroeconomic assumptions under the Base Case and C&SD's population projection.

11. In **nominal** terms, GDP is projected to grow at **4.4% per annum**, lower than the average growth at 6% per annum in the recent five years since 2009-10, though higher than the 17-year average since 1997-98 of 2.9% per annum given the distortions of economic downturns.

12. To test the robustness of the fiscal projections, **High Case and Low Case** sensitivity analyses have been performed assuming that from 2019 onwards, GDP growth per annum would be **0.5 percentage point higher and lower** respectively than that adopted for the Base Case. A purely hypothetical **Shock Case** was also constructed assuming that the economy would dip into a recession in 2015 and 2016, recover in a sluggish manner between 2017 and 2019 and return to the growth path as that in the Base Case from 2020 onwards. The projected average GDP growth rates per annum from 2014 to 2041 under the different cases are summarised below –

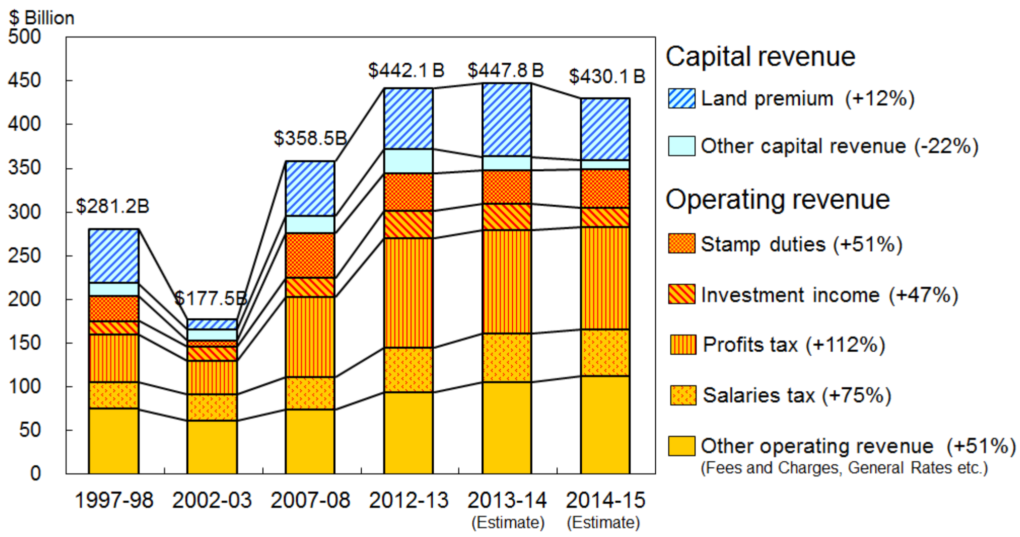
| | **Base Case** | **High Case** | **Low Case** | **Shock Case** |
|---|---|---|---|---|
| Real GDP | 2.8% | 3.3% | 2.4% | 2.0% |
| Nominal GDP | 4.4% | 5.3% | 3.6% | 2.9% |

Unless otherwise indicated, the projections described in this report refer to the Base Case.

## Government Revenue

13. Profits tax, salaries tax, land premium, stamp duty and investment income are the major revenue sources of the Government, contributing about 75% of the estimated total revenue in 2014-15.

*Government revenue growth since 1997-98*




14. For the **17 years from 1997-98**, government revenue would increase by a cumulative 52.9% from $281.2 billion in 1997-98 to $430.1 billion in 2014-15. This represents a **growth of 2.5% per annum**, which is comparable to the average nominal GDP growth rate of 2.9% per annum during the same period. In other words, the growth in government revenue has been broadly commensurate with the growth of the economy in the long run when the effects of economic cycles smoothen out.

15. For the **five years from 2009-10**, total government revenue would grow at an average of **6.2% per annum**, from $318.4 billion in 2009-10 to $430.1 billion in 2014-15. This growth rate also follows closely the 6.0% per annum growth in nominal GDP for the same period.

16. Despite the recent increases in government revenue, there are **underlying concerns** that government revenue is narrow-based and volatile, and that an ageing population would add to the burden of the next generation of taxpayers and the community at large. Specifically –

(a) The Government is increasingly reliant on direct tax revenue, land premium and investment income to finance its expenditure. Direct tax (profits tax, salaries tax and property tax) was 56% of all tax revenue in 1997-98 and 65% in 2012-13. Contribution from fees and charges, a more stable revenue item, dropped from 4% in 1997-98 to 2.6% in 2012-13.

(b) The tax base of profits tax has remained low, with only 11% of (or 94 900) registered corporations paying profits tax for the 2011-12 tax year, compared with 14% for 2007-08 and 2002-03. The top-paying 700 to 800 corporations contributed 64.4% of the overall profits tax revenue for the 2011-12 tax year, compared with 61% for the 1997-98 tax year.

(c) Only 45% of the working population paid salaries tax for the 2011-12 tax year. Reliance on the high-income individuals is also on the rise. In 2011-12 tax year, the top 200 000 salaries tax payers contributed 81.7% of the salaries tax; in 1997-98, they contributed 71.6%.

(d) Government revenue is highly sensitive to the performance of the economy and tends to react to economic upswings and downswings more dramatically than the economy itself. The following illustrates the volatility of key revenue sources since 1997-98 –

| Revenue item | Range from 1997-98 to 2013-14 | | Estimated revenue in 2014-15 | |
|---|---|---|---|---|
| | % of GDP | equivalent $ Billion | % of GDP | equivalent $ Billion |
| Profits tax | 2.9% - 6.2% | 37.7 - 125.6 | 5.3% | 117.6 |
| Salaries tax | 1.9% - 2.7% | 25.1 - 51.8 | 2.4% | 52.9 |
| Stamp duties | 0.6% - 3.1% | 7.5 - 51.5 | 2.0% | 43.8 |
| Land premium | 0.4% - 4.6% | 5.4 - 62.5 | 3.2% | 70.0 |
| Investment income | 0.1% - 3.3% | 0.9 - 41.9 | 1.2% | 27.0 |
| Other revenue | 4.6% - 7.0% | 77.7 - 88.0 | 5.3% | 118.8 |
| Total revenue | 13.3% - 22.6% | 175.6 - 437.7 | 19.4% | 430.1 |

(e) With an ageing population, the workforce size is projected to reach its peak in 2018 and dwindle throughout the 2020s. There will be pressure on salaries tax and other operating revenues.

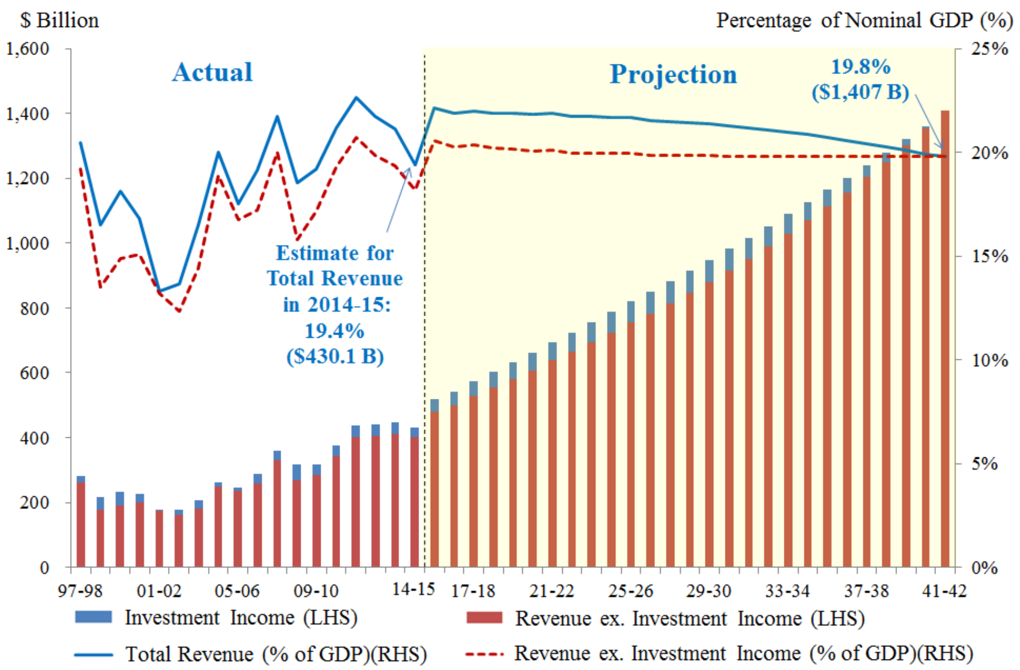
17. Although government revenue swings along with and in the same direction as fluctuations in the local and global economy, **government revenue as a percentage of nominal GDP has seldom exceeded 20%** (only seven times in the past 40 years). Government revenue was on average 18.6% of nominal GDP between 1997-98 and 2012-13, with 13.3% being the trough and 22.6% the peak. This essentially reflects the inherent low tax regime in Hong Kong. Given the protection stipulated in Article 108 of the Basic Law, it would be hard to expect major hikes in government revenue beyond 20% of nominal GDP.

18. Looking ahead, **long-term projections on government revenue** are derived through an **econometric model** that analyses the historical relationship between the major revenue items and the boom-bust cycle of the macro economy, with data collated over an extended period from 1991-92.

19. Government revenue before investment income is projected to grow at 4.7% per annum. The projected trend growth broadly aligns with the projected trend growth in nominal GDP (4.4% per annum).

20. Investment income is projected using an assumed 5% annual rate of return (which is the actual rate of return for 2013-14 and is broadly comparable to the average investment return of 5.3% on the fiscal reserves for the five-year period from 2010-11 to 2014-15) on the average fiscal reserves balance. After taking into account investment income, government revenue is projected to **grow at 4.5% per annum** under the **No Service Enhancement Scenario** (please also see paragraph 28(a) below). This lies roughly in the mid-range of the 17-year average growth since 1997-98 at 2.5% per annum and the five-year average growth since 2009-10 at 6.2% per annum. Government revenue as ratio of nominal GDP is projected at 19.8% in 2041-42; or in dollar terms, to rise from $430.1 billion in 2014-15 to $1,407 billion in 2041-42.

*Projection on government revenue*



21. The projected revenue by 2041-42 under the various macroeconomic cases and expenditure scenarios (see paragraph 28 below) is summarised below –

| **Expenditure Scenarios** | **Base Case** | **High Case** | **Low Case** | **Shock Case** |
|---|---|---|---|---|
| **No Service Enhancement** | | | | |
| - $ Billion | 1,407 | 2,285 | 937 | 943 |
| - % of nominal GDP | 19.8% | 25.8% | 16.5% | 19.8% |
| - Average growth per annum | 4.5% | 6.4% | 2.9% | 2.9% |
| **Service Enhancement at 1% per annum** | | | | |
| - $ Billion | 1,407 | 2,135 | 937 | 943 |
| - % of nominal GDP | 19.8% | 24.1% | 16.5% | 19.8% |
| - Average growth per annum | 4.5% | 6.1% | 2.9% | 2.9% |
| **Service Enhancement at 2% per annum** | | | | |
| - $ Billion | 1,407 | 2,076 | 937 | 943 |
| - % of nominal GDP | 19.8% | 23.5% | 16.5% | 19.8% |
| - Average growth per annum | 4.5% | 6.0% | 2.9% | 2.9% |
| **Service Enhancement at Historical Trend** | | | | |
| - $ Billion | 1,407 | 2,076 | 937 | 943 |
| - % of nominal GDP | 19.8% | 23.5% | 16.5% | 19.8% |
| - Average growth per annum | 4.5% | 6.0% | 2.9% | 2.9% |

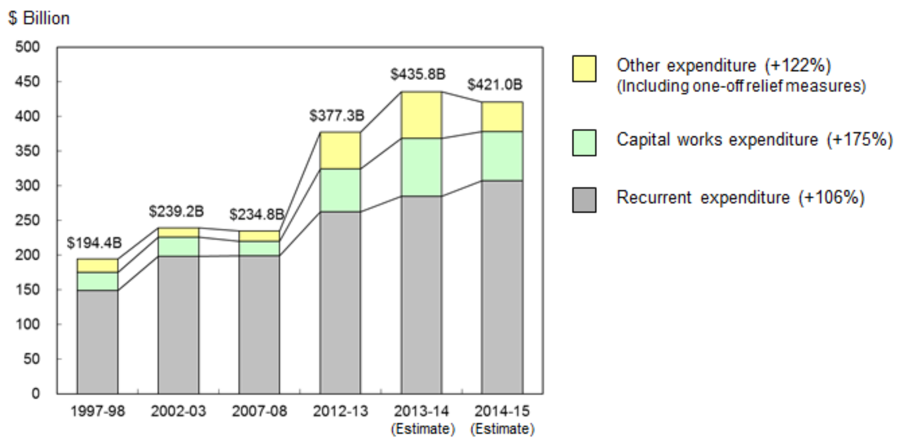
## Government Expenditure

22. Government expenditure comprises operating expenditure (recurrent and non-recurrent) and capital expenditure (primarily capital works). In the context of this report, capital works include funding under the Capital Works Reserve Fund and the Lotteries Fund. Education, social welfare and health are the key recurrent expenditure portfolios, accounting for some 60% of Government's recurrent expenditure, which would amount to $307.4 billion in 2014-15.

23. For the **17 years from 1997-98**, government expenditure would grow on a cumulative basis by 116.6%, from $194.4 billion in 1997-98 to $421.0 billion in 2014-15 (including repayment of $9.8 billion in bonds and notes). This implies an average growth of **4.7% per annum**, which **exceeds** the 2.5% per annum growth in government revenue, and the 2.9% per annum growth in nominal GDP in the same period.

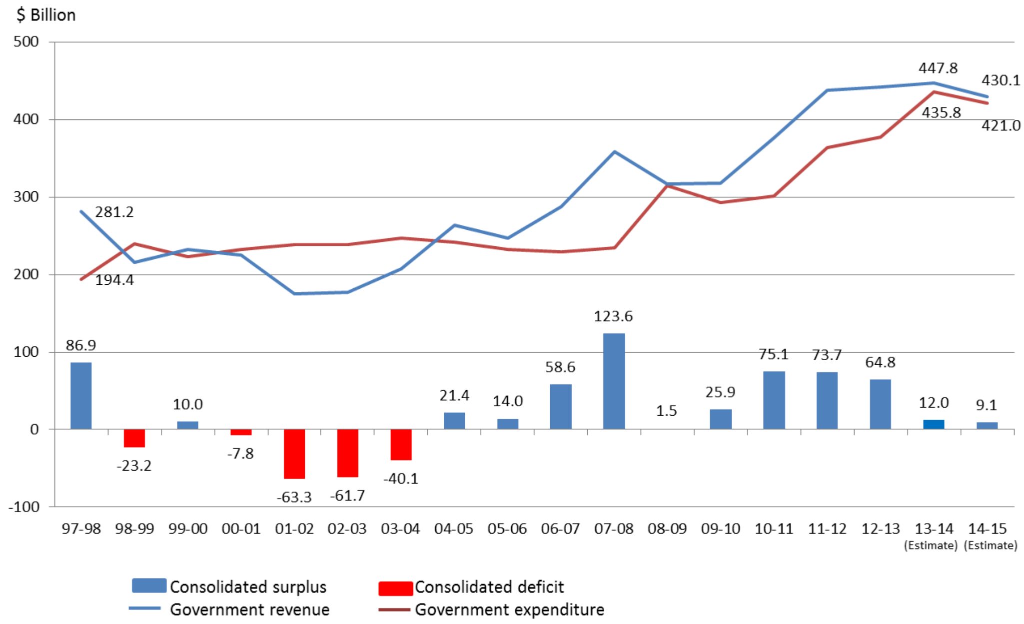
24. For the **five years from 2009-10**, government expenditure would increase from $292.5 billion in 2009-10 to $421.0 billion in 2014-15. This reflects an average growth of **7.5% per annum**, which **exceeds** the 6.2% per annum growth in revenue and the 6% per annum growth in nominal GDP during the same period. It also **outpaces** the post-handover average annual growth of 4.7% in government expenditure.

*Government expenditure growth since 1997-98*



25. Although government expenditure has grown faster than government revenue and nominal GDP on average, Hong Kong still managed to achieve budget surpluses since 2004-05 because government expenditure was strictly contained between $220 billion and $250 billion for ten years between 1998-99 and 2007-08; and by 2007-08, government expenditure was $234.8 billion, way less than government revenue at $358.4 billion. Given a lower base, government expenditure can therefore grow faster than revenue in recent years without triggering budget deficits.

*Financial highlights since 1997-98*




26. Although we manage to achieve ten years of budget surplus since 2004-05, it is **not sustainable to allow government expenditure to persistently grow faster than government revenue and nominal GDP.** Nor would this be in line with the requirement of Article 107 of the Basic Law for the Hong Kong Special Administrative Region *"to keep the budget commensurate with the growth of its gross domestic product"*.

27. The Working Group sees a need to pay **greater regard to longer term affordability and fiscal sustainability**. Obviously, population ageing would exert pressure on government expenditure and undermine economic and revenue growth. There are inherent inelasticities in government expenditure. Over 10% of the Government's recurrent expenditure relates to social security payments; another 30% relates to personal emoluments and related expenditure for the Government and 30% relates to payouts of similar nature for the subvented sector. As revealed by the past trends, these payments tend to go up more frequently and quickly than going down. Besides, fiscal reserves can be depleted faster than one might expect. In the six years from 1998-99, Government used up some $200 billion of the fiscal reserves. As at end-March 2014, outstanding commitments from capital works would amount to $340 billion, statutory pension liabilities over $700 billion and debt guarantees $80 billion.

28. Looking ahead, the Working Group has examined the recurrent expenditure requirements for the three policy area groups which are particularly sensitive to demographic changes – namely, **education**, **social welfare** and **health**. They account for the lion's share (about 60%) of the Government's recurrent expenditure in 2014-15. Four projection scenarios have been developed for each –

(a) Under the **No Service Enhancement Scenario**, it is assumed that there would be **no** policy changes and **no** service improvements in these three areas from now to 2041-42. The two key variables determining their recurrent expenditure requirements under this scenario are **demographic changes** and **price changes**.

(b) With the scenario at (a) above as the building block, three Service Enhancement Scenarios have been developed –

(i) **Service Enhancement at 1% per annum** assumes that recurrent expenditure on education, social welfare and health would grow at 1% per annum on top of demographic changes and price changes;

(ii) **Service Enhancement at 2% per annum** is the same as (i) except that recurrent expenditure on the three areas is assumed to grow at 2% per annum on top of demographic changes and price changes; and

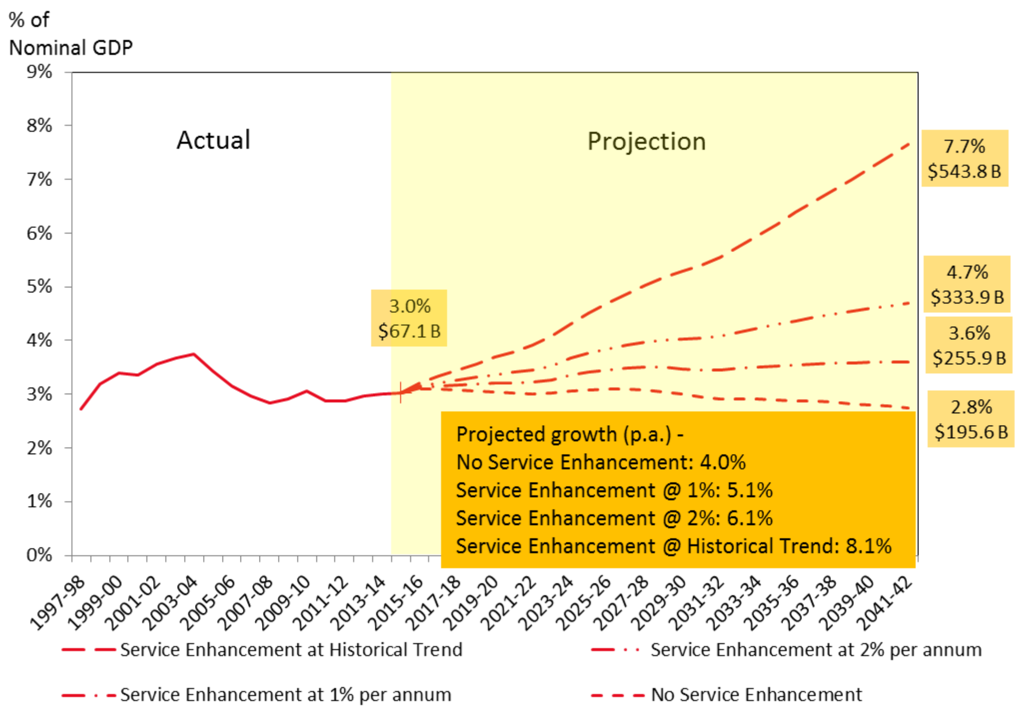
(iii) **Service Enhancement at Historical Trend** assumes that services for education, social welfare and health would be enhanced, at 3.86%, 2.8% and 2.63% per annum respectively (or on average, 3% per annum collectively for the three sectors) trailing historical trends. In the fields of education and social welfare, the trends since 1997-98 have been used. In the field of health, the Working Group adopted the trend rate since 2007-08 to take away the distortions caused by the outbreak of SARS in 2003-04.

## Education

29. Under the **No Service Enhancement Scenario**, recurrent education expenditure as a percentage of nominal GDP would drop from 3% in 2014-15 to 2.8% in 2041-42, mainly owing to the expected decline in total population for the age group of 3 to 21. In dollar terms, there would still be an increase from $67.1 billion to $195.6 billion. It reflects a growth rate of **4.0% per annum**.

30. Under the three **Service Enhancement Scenarios**, recurrent education expenditure as a percentage of nominal GDP would increase from 3% in 2014-15 to between 3.6% and 7.7% in 2041-42; or in dollar terms, from $67.1 billion to between $255.9 billion and $543.8 billion. This reflects a projected trend growth rate of **5.1% to 8.1% per annum**, exceeding the post-handover average annual growth of 3.5% in recurrent education expenditure.

*Recurrent education expenditure*

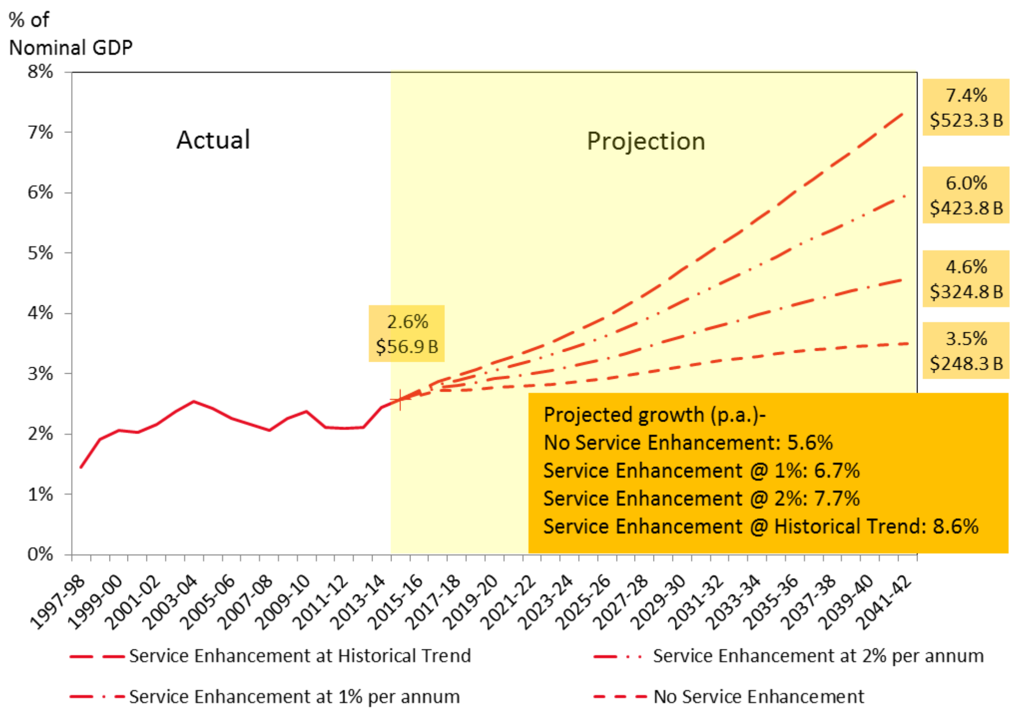


**Social welfare**

31. Under the **No Service Enhancement Scenario**, recurrent social welfare expenditure as a percentage of nominal GDP would increase from 2.6% in 2014-15 to 3.5% in 2041-42; or in dollar terms, from $56.9 billion to $248.3 billion. It reflects a growth rate of **5.6% per annum**.

32. Under the three **Service Enhancement Scenarios**, recurrent social welfare expenditure as a percentage of nominal GDP would increase from 2.6% in 2014-15 to between 4.6% and 7.4% in 2041-42; or in dollar terms, from $56.9 billion to between $324.8 billion and $523.3 billion. This implies a projected trend growth rate of **6.7% to 8.6% per annum**, higher than the post-handover average annual growth of 6.4% in recurrent social welfare expenditure.

*Recurrent social welfare expenditure*

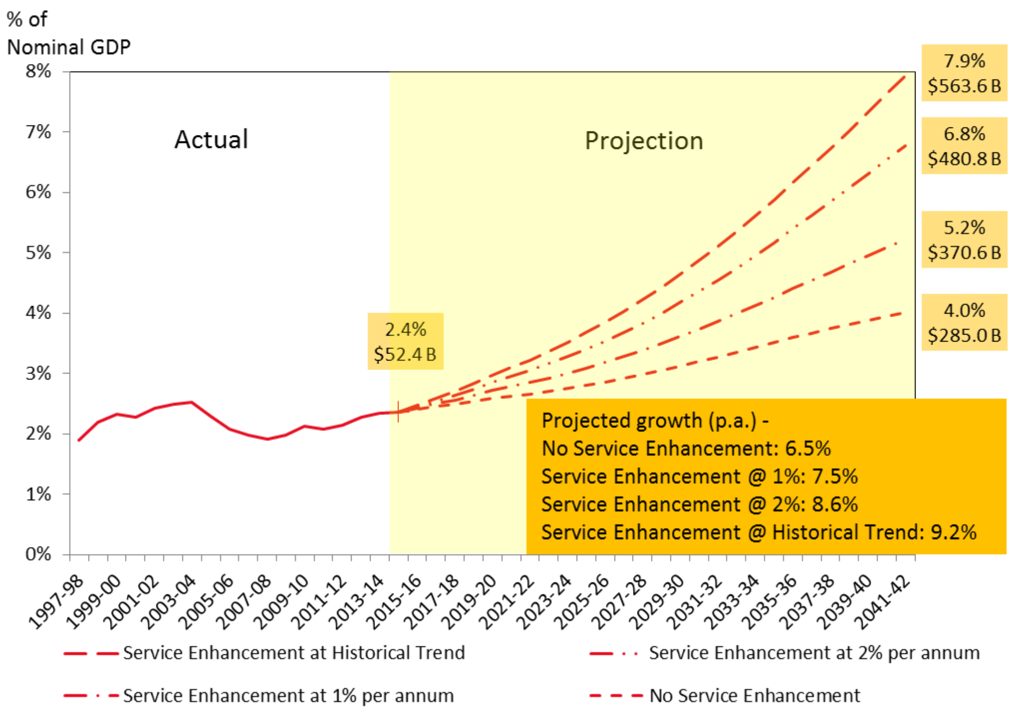


**Health**

33. Under the **No Service Enhancement Scenario**, recurrent health expenditure as a percentage of nominal GDP would increase from 2.4% in 2014-15 to 4.0% in 2041-42; or in dollar terms, from $52.4 billion to $285.0 billion. It reflects a growth rate of **6.5% per annum**.

34. Under the three **Service Enhancement Scenarios**, recurrent health expenditure as a percentage of nominal GDP would increase from 2.4% in 2014-15 to between 5.2% and 7.9% in 2041-42; or in dollar terms, from $52.4 billion to between $370.6 billion and $563.6 billion. This implies a projected trend growth rate of **7.5% to 9.2% per annum**, higher than the post-handover average annual growth of 4.2% in recurrent expenditure on health services.

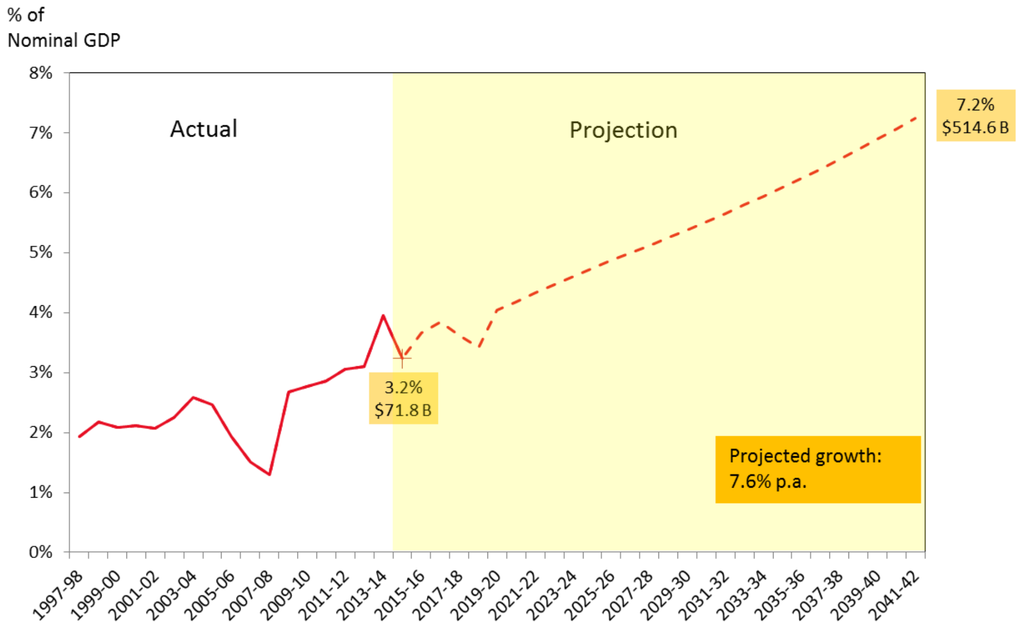
*Recurrent health expenditure*



### Capital works

35. The cash flow requirements on capital works tend to be volatile. Over a period of some 30 years (from 1982-83 upon the establishment of the Capital Works Reserve Fund to 2014-15), capital works expenditure was on average 3.4% of real GDP. The Working Group assumes that capital works expenditure would be maintained at 3.4% of real GDP over the forecast period. Despite this, construction prices tended to and are assumed to rise faster than general inflation as measured by the GDP deflator. In terms of nominal GDP, capital works expenditure is projected to increase from 3.2% in 2014-15 to 7.2% in 2041-42. In dollar terms, capital works expenditure is projected to increase from $71.8 billion to $514.6 billion, at a growth rate of **7.6% per annum**, higher than the post-handover average annual growth of 6.0%.

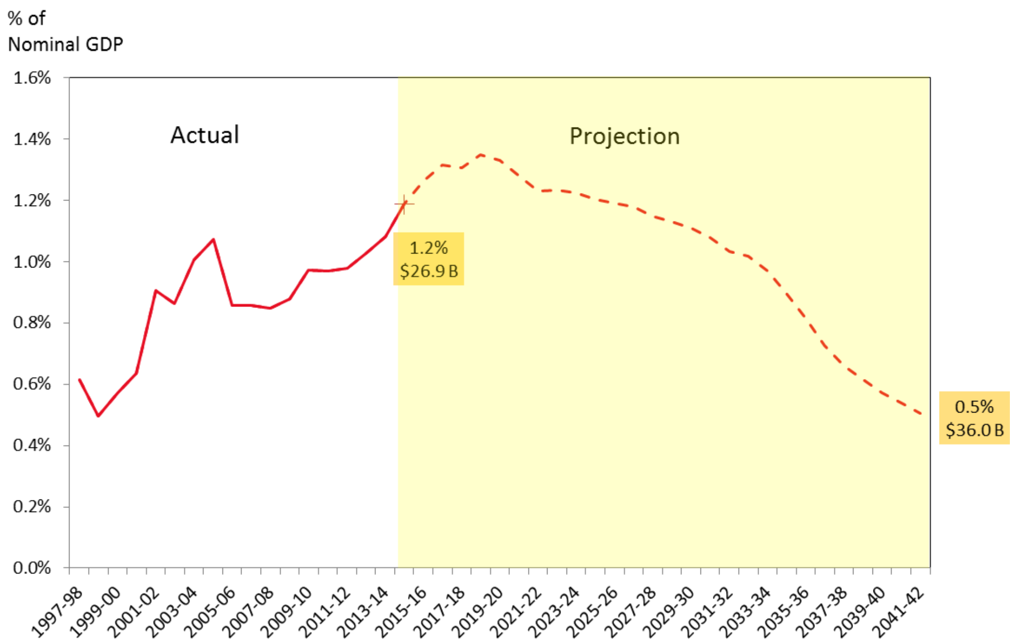
*Capital works expenditure*



### Statutory pension liabilities

36. On the basis of an actuarial assessment on pension liability updated in October 2013, it is projected that the Government's expenditure on public and judicial service pension benefits would increase gradually from $26.9 billion in 2014-15 to the **peak at $50.9 billion in 2032-33**, when most of the pensionable officers would be retiring and receiving their lump sum pension gratuities over the period. The expenditure is projected to decrease henceforth to $36 billion by 2041-42. In terms of percentage of nominal GDP, pension expenditure would be 1.2% in 2014-15 and 0.5% in 2041-42.

*Statutory pension expenditure*



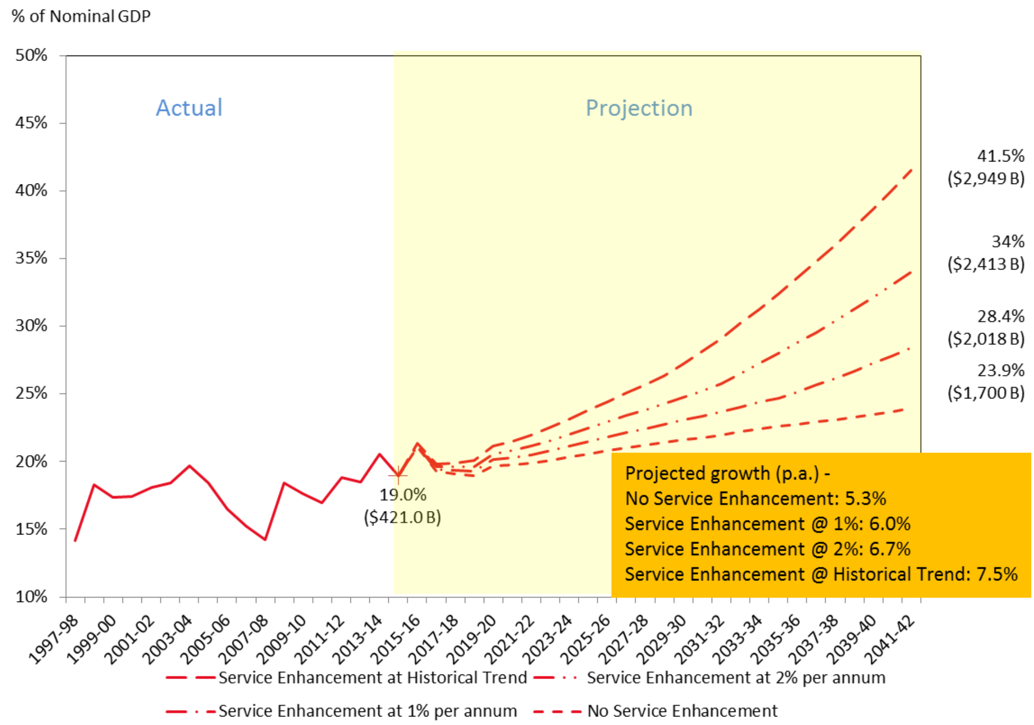

### Total government expenditure

37. Taking into account the above expenditure projections, together with the projections for other recurrent, non-recurrent and other capital expenditure (which are assumed to be maintained at their current share of GDP over the projection period), total government expenditure is projected to increase from 19.0% of nominal GDP in

2014-15 to 23.9% in 2041-42 under the Base Case **No Service Enhancement Scenario**. In dollar terms, the increase would be more than three times from $421.0 billion in 2014-15 to $1,700 billion in 2041-42. This reflects a projected trend growth in government expenditure of **5.3% per annum**, which is higher than the projected trend growth in nominal GDP of 4.4% per annum.

38. Under the three **Service Enhancement Scenarios**, total government expenditure as a percentage of nominal GDP is projected to increase from 19.0% in 2014-15 to between 28.4% and 41.5% in 2041-42. In dollar terms, the increase would be five to six times from $421.0 billion in 2014-15 to between $2,018 billion and $2,949 billion in 2041-42. This implies a projected trend growth in government expenditure of **6.0% to 7.5% per annum.** The projected expenditure growth **exceeds** the post-handover average annual growth of 4.7% in government expenditure. It also **exceeds** the projected nominal GDP growth of 4.4% per annum.

*Total government expenditure*



39. The projected expenditure by 2041-42 under the various macroeconomic cases and expenditure scenarios is summarised below –

| **Expenditure Scenarios** | **Base Case** | **High Case** | **Low Case** | **Shock Case** |
|---|---|---|---|---|
| **No Service Enhancement** | | | | |
| - $ Billion | 1,700 | 2,010 | 1,544 | 1,393 |
| - % of nominal GDP | 23.9% | 22.7% | 27.1% | 29.3% |
| - Average growth per annum | 5.3% | 6.0% | 4.9% | 4.5% |
| **Service Enhancement at 1% per annum** | | | | |
| - $ Billion | 2,018 | 2,258 | 1,829 | 1,646 |
| - % of nominal GDP | 28.4% | 25.5% | 32.1% | 34.6% |
| - Average growth per annum | 6.0% | 6.4% | 5.6% | 5.2% |
| **Service Enhancement at 2% per annum** | | | | |
| - $ Billion | 2,413 | 2,660 | 2,186 | 1,965 |
| - % of nominal GDP | 34.0% | 30.1% | 38.4% | 41.3% |
| - Average growth per annum | 6.7% | 7.1% | 6.3% | 5.9% |
| **Service Enhancement at Historical Trend** | | | | |
| - $ Billion | 2,949 | 3,253 | 2,670 | 2,398 |
| - % of nominal GDP | 41.5% | 36.8% | 46.9% | 50.4% |
| - Average growth per annum | 7.5% | 7.9% | 7.1% | 6.7% |

## Structural Deficits Looming

40. The Working Group has consolidated the revenue and expenditure projections to deduce the overall fiscal outlook for Hong Kong under the various scenarios. The projected annualised trend growth rates of GDP, government revenue and government expenditure are as follows –

| | **Projected Trend Growth (Base Case, No Service Enhancement Scenario)** | **Trend Growth in recent years** | |
|---|---|---|---|
| | 2014-15 to 2041-42 | 1997-98 to 2014-15 | 2009-10 to 2014-15 |
| Real GDP | 2.8% | 3.4% | 3.9% |
| Nominal GDP | 4.4% | 2.9% | 6.0% |
| Government revenue | 4.5% | 2.5% | 6.2% |
| Government expenditure | 5.3% | 4.7% | 7.5% |

41. Despite the healthy state of our public finances at the moment, the Base Case **No Service Enhancement Scenario** reveals that a **structural deficit** could strike in 2029-30 (within 15 years) even if services for the education, social welfare and health sectors were to be maintained at existing levels, and expenditure would grow merely with price changes and demographic changes. The problem could surface much earlier (within a decade) under the **Service Enhancement Scenarios**.

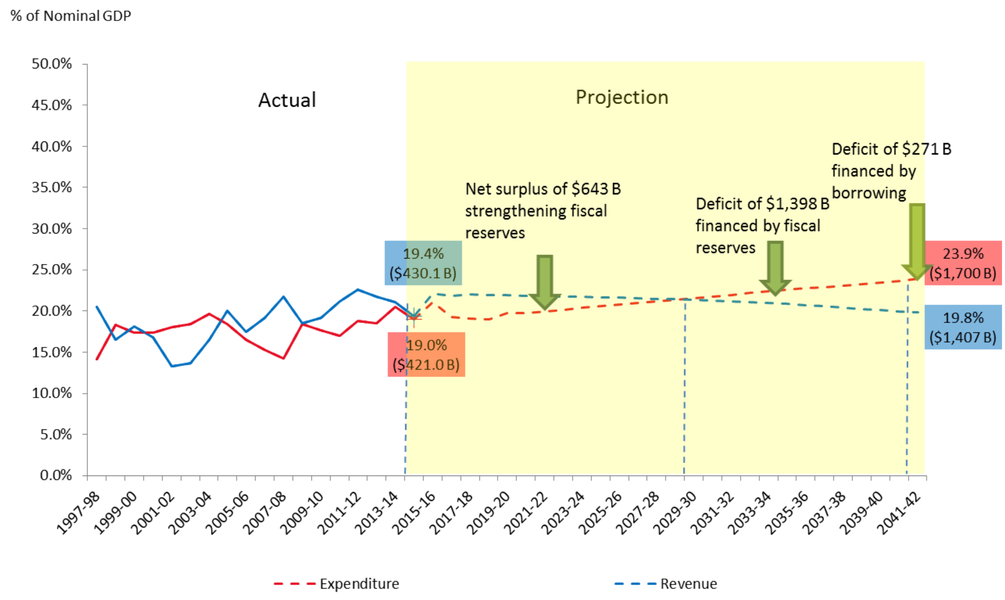
42. Unless the Government takes timely, resolute and effective measures to address the problem, the healthy state of our public finance would deteriorate gradually under the No Service Enhancement Scenario and more rapidly under the three Service Enhancement Scenarios, by phases –

(a) **Living with surplus** – government revenue is still projected to exceed government expenditure in the coming years and the Government would still be able to build up the fiscal reserves. The good years ahead will give the community a false sense of security.

(b) **Living on reserves** – a structural deficit could surface within a decade or two should government expenditure growth keep exceeding revenue growth. The Government would be dipping into the fiscal reserves to fund the shortfalls. Depending on the expenditure pattern, this could last for seven to 12 years.

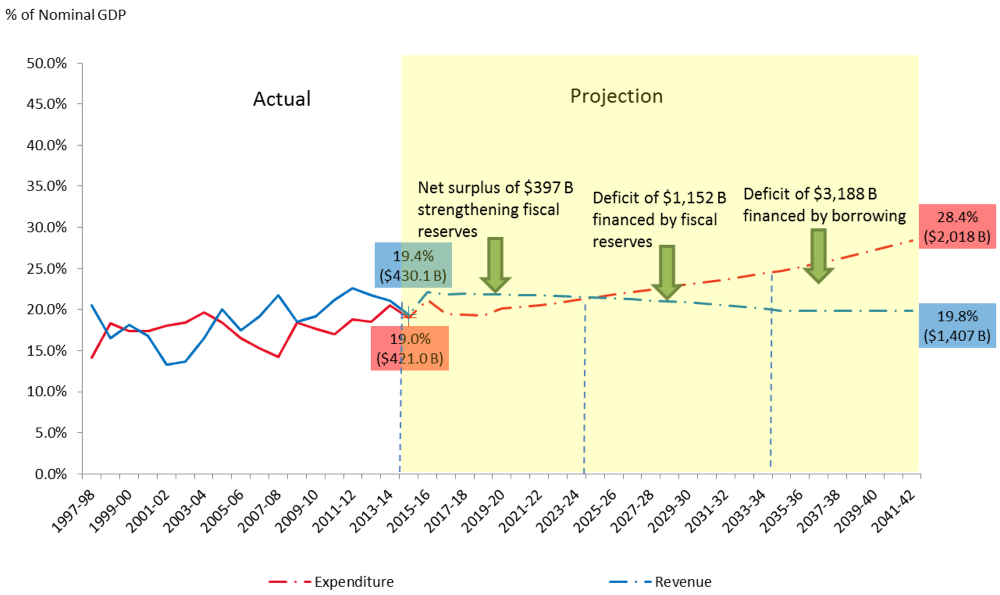
(c) **Living on borrowing** – upon exhaustion of fiscal reserves, the Government would have no choice but to borrow to make ends meet. Debt liabilities could escalate quickly.

*Fiscal outlook: Base Case, **No Service Enhancement** Scenario*

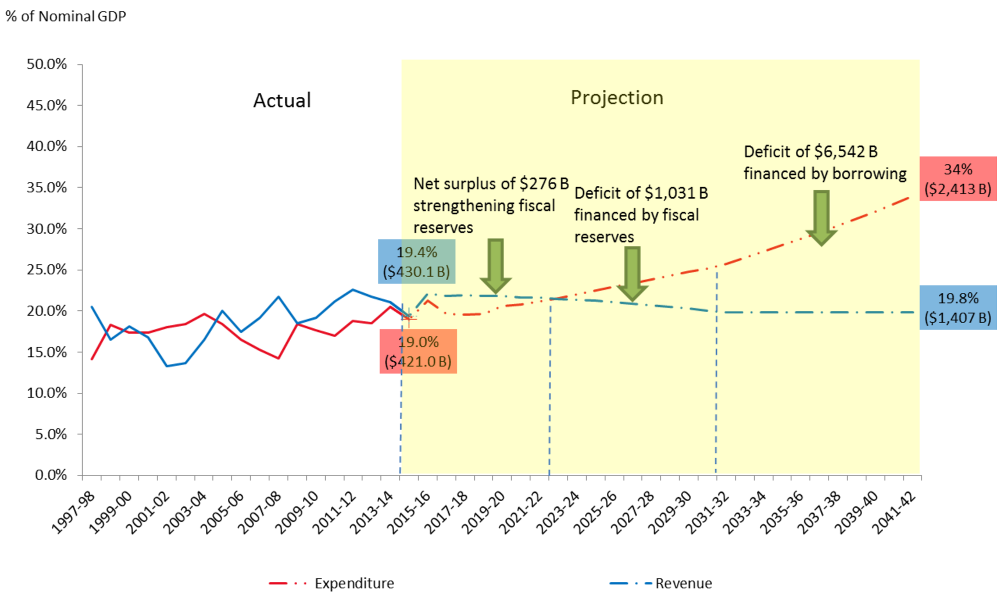


*Fiscal outlook: Base Case, **Service Enhancement** Scenarios*

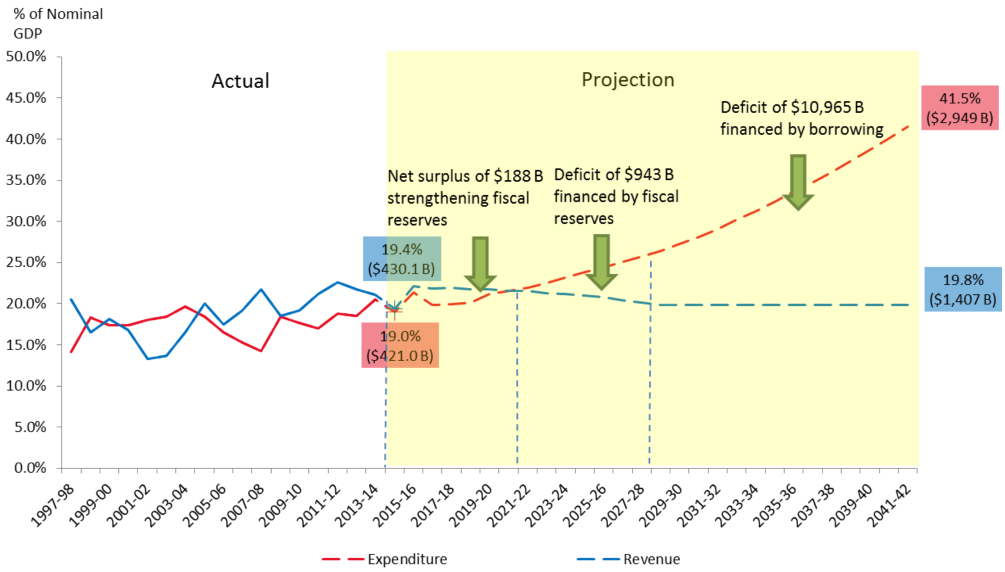
*@1% per annum*



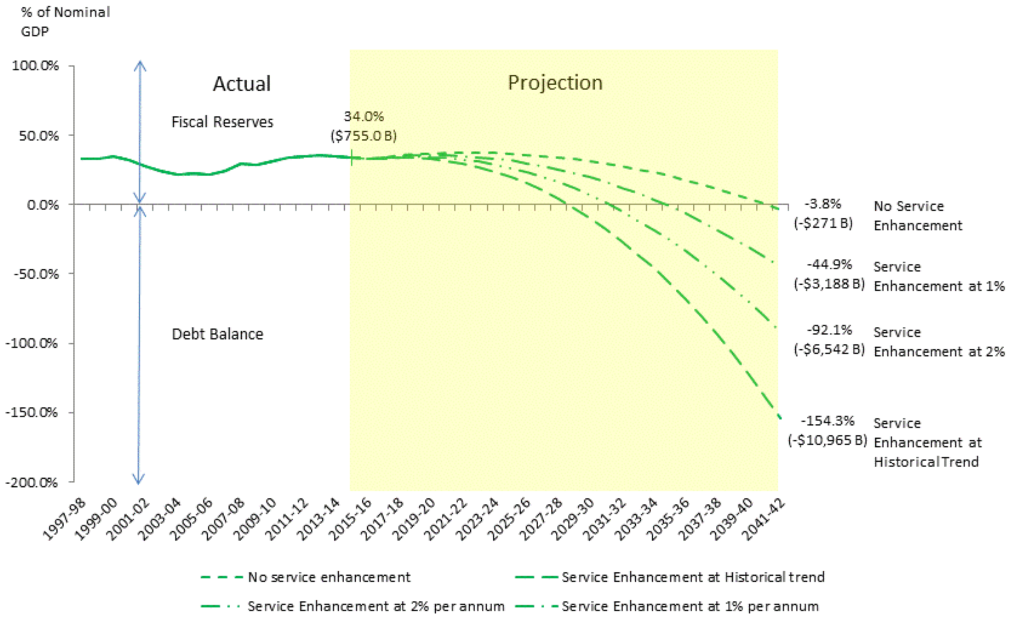

*@2% per annum*



*@ Historical Trend*




*Projection on fiscal reserves / debt balance under Base Case*




43. **The scale of the structural deficit could be serious**. Except for the No Service Enhancement Scenario under the High Case, a structural deficit is projected to surface within a decade or two under all other scenarios. The fiscal gap by 2041-42 could range from 4.1% of nominal GDP under the Base Case with No Service Enhancement Scenario to between 14.8% and 30.6% of nominal

GDP under the Shock Case with Service Enhancement Scenarios. Fiscal reserves could be depleted within another decade after the onset of structural deficit.

44. If a structural deficit were to be avoided, Hong Kong would need a real GDP trend growth of 3.1% per annum under the No Service Enhancement Scenario, or growths of 3.6%, 4.4% or 5.4% per annum under the Service Enhancement Scenarios, instead of the 2.8% per annum assumed under the Base Case. Since Hong Kong has moved away from a high-growth developing economy in the 1970s and 1980s and is now a mature economy, and since the labour force is expected to dwindle as from 2018 under an ageing population and existing population policies, a trend GDP growth of over 3% per annum is exceedingly hard to achieve under current policies. This is a clear wake-up call; there is no room for complacency.

45. The Working Group has made a conscious effort to avoid overstating expenditure requirements. The foregoing has **not taken into account the enormous fiscal pressure which the Housing Authority is under, and which might need to be shouldered in part by the Government.** Even under the 2013 commitment to produce an average of 20 000 public rental housing (PRH) and 5 000 Home Ownership Scheme units a year, the Housing Authority is projected to have a funding shortfall as from 2019-20 and the cumulative shortfall to 2041-42 could be **$490 billion** (assuming PRH rent could be raised 5% every two years) **or $130 billion** (assuming PRH rent could be raised 10% every two years). If the Housing Authority’s shortfalls were deemed government obligations, the projection could involve an extra 0.3 to 1.5 percentage points of the nominal GDP in the years requiring Government’s funding support under the No Service Enhancement Scenario. The surface of structural deficit and the depletion of the fiscal reserves could be advanced by three years.

46. Also, the projections have not taken into account the financial implications that could arise from policy initiatives under consultation or review, including those relating to kindergarten education, health protection scheme (except for the $50 billion set aside for 2015-16), etc.

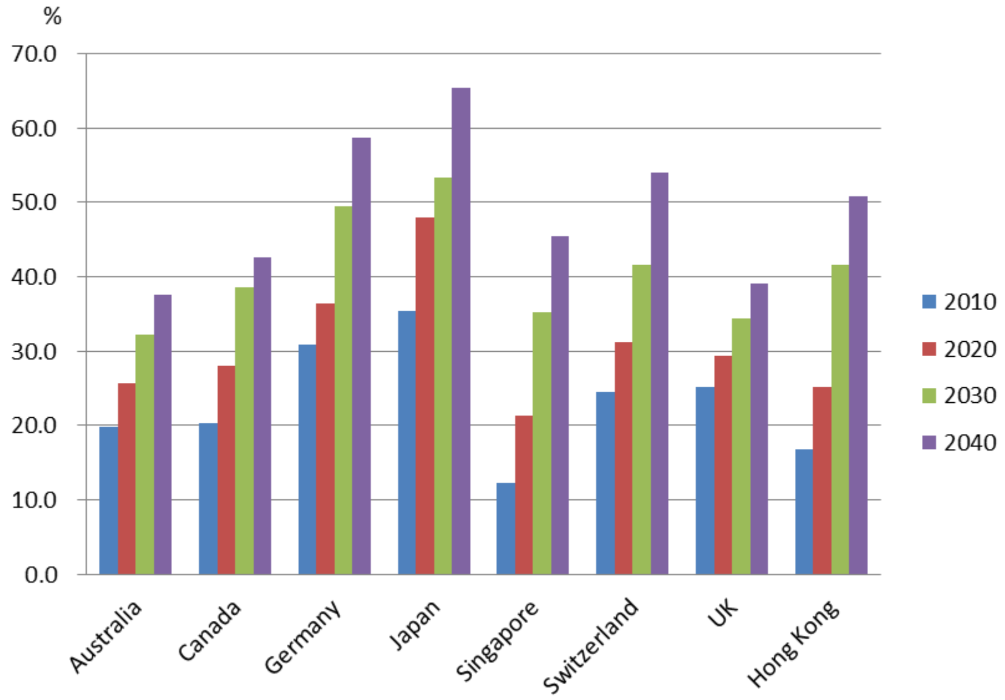
47. Long-term projections are not year-on-year forecasts. There are bound to be limitations. But transparency facilitates understanding. Projections under various cases and scenarios in the report can be found in the website of the Treasury Branch, Financial Services and the Treasury Bureau. The Working Group would not wish the inherent limitations of long-term projections to obscure a proper recognition of the fiscal problem ahead.

## Fiscal Measures Adopted in Other Economies

48. The Working Group has chosen a sample of seven economies for review, focusing particularly on the budget measures they have adopted to consolidate their budgetary positions. These economies are Australia, Canada, Germany, Japan, Singapore, Switzerland and the United Kingdom. The Working Group has also made reference to the publications issued by the International Monetary Fund and the Organisation for Economic Co-operation and Development.

49. Population ageing of the selected economies, as illustrated below, poses pressures on their fiscal systems –

*Projection on elderly dependency ratio of the seven selected economies and Hong Kong*




*Source: Other economies - United Nations Probabilistic Population Projections*
*Singapore - Department of Statistics, Singapore Government*

50. In the face of fiscal problems, many of these economies have introduced measures to ensure fiscal sustainability. These include introducing savings schemes, enforcing or tightening fiscal disciplines, containing expenditure, reviewing operational efficiency, setting limits on debts, preserving revenue base and increasing taxes, etc.

## Proposed Fiscal Measures

51. The Working Group has identified and analysed fiscal measures to address the longer term funding needs of Hong Kong. While it is important for the Government to continue promoting the growth of the economy, the key to resolving the anticipated structural deficit or reducing its quantum is to contain the growth of government expenditure, along with safeguarding the revenue base. The Working Group has the following suggestions –

(a) containing expenditure growth;
(b) preserving, stabilising and broadening the revenue base;
(c) saving for the future;
(d) segregating and balancing the Operating and Capital Accounts;
(e) making clear what the fiscal reserves cover;
(f) stepping up the management of the Government's assets; and
(g) sustaining the financial health of the Housing Authority.

To prevent or delay the structural deficit problem, an appropriate mix of fiscal measures should be drawn up as soon as practicable for implementation at the right timing. The above suggestions are not mutually exclusive. Nor would any single one of them suffice.

### (A) Containing expenditure growth

52. The Working Group sees the need to contain overall government expenditure growth within the forecast nominal GDP growth rates and to **keep the public expenditure at or around 20% of GDP**. In practical terms, this would entail a much smaller year-on-year growth rate than that in recent years; it would imply a lower or even negative real growth through cutting back existing services, and offsetting extraordinary expenditure growth in one policy area group by reduction within or in other areas. **Fiscal sustainability should be assessed for major recurrent spending initiatives** exceeding $100 million. The public service should remain lean

and efficient. **Fundamental expenditure reviews** should be undertaken for key spending bureaux and departments and subvented bodies. Service-wide economy drive and re-engineering and re-prioritisation drives should also be launched periodically. The **capital works programme should be managed** and moderated to grow more in line with nominal GDP.

**(B) Preserving, stabilising and broadening the revenue base**

53. The Working Group **recommends** that the main priority on the revenue side is to **preserve, stabilise and broaden the revenue base**. Specifically, the Government should avoid excessive reliance on direct taxation, step up tax enforcement, and reinforce the "cost recovery", "user pays" and "polluter pays" principles, and should enhance the tax regime to ensure that the tax structure can meet the long-term needs of Hong Kong and the fiscal pressures in the long run.

**(C) Saving for the future**

54. The Working Group **recommends** that **a savings scheme be established** as soon as practicable; this may be achieved by "freezing" the Land Fund and creating a notional "Future Fund" held against the Land Fund for this purpose. It should also not be accounted for as part of the fiscal reserves; it will be presented separately. Other than the initial endowment and investment returns on the Land Fund, the Government would need to consider how occasional top-ups can be offered for the Future Fund, and under what circumstances the Future Fund would be withdrawn. The Working Group believes that the Government would need to consult stakeholders on the exact mode of operation of the Future Fund.

### (D) Segregating and balancing the Operating and Capital Accounts

55. The Working Group **recommends** that –

(a) **operating expenditure should not exceed 90% of the operating revenue**. Surpluses in the Operating Account may help meet shortfalls in the Capital Account or may be retained as reserve, rather than being spent right away; and

(b) the **Capital Account** (primarily funding capital works expenditure) should be **segregated from** the **Operating Account** and should strive to stay within the limits of the capital revenue (primarily revenue from land disposals). Surpluses from the Capital Account, typically one-off in nature, say arising from land sale, should **not** be used to fund recurrent initiatives under the Operating Account. **Loan financing** may be considered for meeting **project-based or short-term shortfalls** in the Capital Account, subject to the cost of borrowing not exceeding the expected earnings on the fiscal reserves otherwise drawn down, and the government debt level **not exceeding 5% of GDP**. The proposed cap applies to project-based or short-term loan financing for the Capital Account.

### (E) Making clear what the fiscal reserves cover

56. Of the $745.9 billion estimated fiscal reserves as at end March 2014, only the portion held in the General Revenue Account (about $394 billion) is for meeting the day-to-day cash flow requirements of the Government; the balance held in the Land Fund (about $220 billion) has **no authorised use**; and the balances held in various Funds (e.g. Capital Works Reserve Fund, Innovation and Technology Fund, Loan Fund, Lotteries Fund) set up by Resolutions of the Legislative Council (about $132 billion) **have their respective designated use**. The Working Group **recommends** that this should be made clear and explained to the general public.

### (F) Stepping up the management of the Government's assets

57. The Working Group **recommends** that the Government should **manage its asset portfolio more proactively**, through asset disposal or securitization for instance, and use the financial return to help reduce the fiscal pressures in the coming decades. The Working Group also **recommends** that the Government should ensure that government business enterprises are managed and operated efficiently and cost-effectively.

### (G) Sustaining the financial health of the Housing Authority

58. The Working Group **recommends** that the Government should negotiate with the Housing Authority with a view to reducing the budgetary pressure on government finances in the long run. The Working Group believes that the Government should review with the Housing Authority its business model so as to meet its statutory requirement to make ends meet on a recurrent basis.

## Planning for the Future

59. As Hong Kong gears up for tougher times ahead, the Government and the community must pay heed to the pressures on fiscal sustainability and must act in a responsible manner. The Working Group sees a need for fiscal discipline to be tightened. It does **not** mean stalling all new and worthy initiatives – because the economy is still projected to grow, albeit at a slower pace. But it does require greater regard to long-term affordability, and readiness to accept offsetting savings. It requires collective effort to preserve, stabilise and where possible broaden the revenue base, and to safeguard the cost-recovery principle. It also requires advance planning, so that the Government can start saving for the future. Community expectations will need to be managed.

60. The Working Group appreciates that the scale of the structural deficit problem is enormous and the problem is too big for the Government alone to resolve. In considering options ahead, the Working Group sees a need for the Government to consider options for partnerships with the private sector, as in the case of public private partnership in capital projects and healthcare reform.

61. The Working Group would not want to paint an overly gloomy fiscal outlook for Hong Kong. But there can be no denial that Hong Kong can ill afford to continue increasing spending beyond the pace of economic growth and revenue. We have to act and behave as a mature economy. The Government and the community would need to acknowledge the problem ahead and adjust. If the Government takes serious and early action to realign the growth of expenditure with that of government revenue and of the economy, the Working Group is reasonably optimistic that the structural gap in public finances can be narrowed and the onset of a structural deficit deferred. Fiscal consolidation would go a long way to preserving the longer term stability, competitiveness and creditworthiness of Hong Kong as an international financial centre.