For information **FCRI(1999-2000)6**

NOTE FOR FINANCE COMMITTEE

Annual Inflation Adjustment of the Standard Payment Rates under the Comprehensive Social Security Assistance Scheme and the Social Security Allowance Scheme

INTRODUCTION

At the Finance Committee (FC) meeting held on 3 April 1998, Members approved *vide* FCR(98-99)10 an upward adjustment of 4.8% to the standard payments under the Comprehensive Social Security Assistance (CSSA) Scheme and the Social Security Allowance (SSA) Scheme with effect from 1 April 1998. In so approving, FC endorsed that an over-estimate of 1.5% in the 1997-98 annual adjustment cycle should be taken into account but instead of deducting that over-estimate from the forecast 4.8% increase for 1998-99, FC agreed that we should extend the period of validity of the new rates from the usual 12-month cycle from April to March to a period of 16 months. In other words, the last inflation adjustment of a 4.8% increase to the standard payments was intended to maintain the purchasing power for the period up to end July 1999. Accordingly, we advised Members that we would next review and adjust as appropriate the standard payments for inflation to take effect from 1 August 1999. This paper informs Members of the outcome of the review.

THE REVIEW

Consumer Prices

2. Consumer price inflation eased distinctly over the course of 1998. Inflation turned negative towards the end of 1998. Consumer prices remained on the decline in the first quarter of 1999 and negative inflation is expected for the whole of 1999, with Composite Consumer Price Index now forecast at a drop of 2.5%. The same downward trend was observed in other sub-indices, including the Social Security Assistance Index of Prices (SSAIP), which is specially compiled to reflect the expenditure pattern of CSSA recipients.

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3. The actual year-on-year movement of SSAIP for 1998-99 turned out to be -0.2%. Moreover, with a forecast negative inflation for the whole of 1999, there is hardly any price increases during the extended period from April to July 1999 for which a projected increase of 1.5% had been made in the last annual inflation adjustment. As a result, taking the current CSSA standard payments and the consumer prices, we are now faced with a total over-estimate of 6.5% (4.8% + 0.2% + 1.5%).

The Adjustment Mechanism

4. At present, we make inflation adjustments to CSSA/SSA standard payments on the basis of the forecast increase in the SSAIP. The practice of making increases based on a projected rate of inflation was intended to avoid putting CSSA recipients in the position of only catching up with past inflation. As discrepancies between the forecast inflation and the actual outturn are inevitable, a well established principle of this methodology is that if the forecast increase in SSAIP proves to be different from the actual increase, we should take the difference into account in calculating the adjustment for the following year. This is to ensure that from a public spending point of view, the payment rates would not be pitched at levels above the intended assistance levels through over-estimation.

5. In practice, the adjustment mechanism and the consequential application of the principle of reconciliation is fraught with problems. First of all, no matter how thorough and sophisticated the forecast is done, it is by its nature liable to discrepancy against the actual outturn[1]. The discrepancies between the forecast and the actual SSAIP movements from 1989-90 onwards are shown in Encl. 1 Enclosure 1. As Members will see, in the past where there was an under-estimate, we invariably made up for the difference in the subsequent year's increase. However, likewise adjustments had not taken place where there was an over-estimate.

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[1] SSAIP forecast is basically derived from a time series model, namely the Auto-Regressive Integrated Moving Average (ARIMA) model, developed by the Census and Statistics Department in collaboration with the Economic Analysis Division. The ARIMA model, which is formula-based rather than judgement-constituted, is a commonly used projection technique for time series analyses in other economies overseas. However, the sharp moderation in inflation in Hong Kong observed since the early part of 1998, in line with the economic adjustment upon the impact of the regional financial turmoil, and in contrast to the higher inflation observed in the earlier years, has magnified the forecast discrepancy. Under such abrupt circumstances, it would be too demanding of such a model to produce a forecast which is deemed likely to come close to the subsequent actual outturn.

6. The above problem and its consequential impact on public spending has been acknowledged by the Director of Audit. In a recent audit investigation into the administration of the CSSA and SSA Schemes from late 1998 to early 1999, the Director of Audit noted, amongst other things, that the combination of the over-estimation of the SSAIP and the deviations from the stated annual inflationary adjustment mechanism in the past years had a significant impact on Government expenditure. He considered that the Administration should adhere to the stated annual inflation adjustment mechanism in future. He further recommended that where there were exceptional circumstances warranting a deviation from the established adjustment mechanism, the Administration should provide full and relevant information to FC.

Level of Standard Payment Rates

7. If we were to follow the established mechanism for annual inflation adjustment, we would have to reduce the current CSSA and SSA standard payments by 6.5% from 1 August 1999. If we were to follow mechanically the forecast inflation approach, we would have to reduce the rates further having regard to the forecast -1.3% SSAIP movement for 1999-2000, thus ending up with a total downward adjustment of 7.8%.

8. It is clear to us that adjusting CSSA/SSA rates downwards in anticipation of deflation (the -1.3% in SSAIP for 1999-2000) goes against the original objective of the forecast methodology. In the light of the Director of Audit's observations and recommendation for adherence to the stated inflation adjustment mechanism, we have considered whether a downward adjustment of 6.5% should be effected, which is no more than restoring the rates to what they justifiably should be. We conclude that it would be undesirable to implement a 6.5% downward adjustment in the standard payment rates from 1 August 1999 because –

(a) Hong Kong has undergone a period of exceptional economic adjustment in the past 18 months or so. This has been an unsettling period for many Hong Kong citizens, especially the low income families. The 6.5% downward adjustment required will affect not only CSSA recipients but also SSA recipients who are either elderly or severely disabled people. For these people, the SSA payment may be providing a useful supplement to their household budget during this period of economic difficulties; and

(b) due to the 4.8% increase in standard payment rates in last year, the extent of downward adjustment now required is in fact larger than the actual negative inflation in 1998-1999. Some CSSA and SSA recipients, especially the elderly and disabled, may find it difficult to adapt to the 6.5% downward adjustment in the standard payment rates.

9. Balancing the interests of CSSA/SSA recipients and the financial implications, we consider that a pragmatic approach would be to maintain the standard payment rates under the CSSA and SSA Schemes at their existing levels until inflation in subsequent years catches up. We will review the year-on-year SSAIP movement on a yearly basis (but see paragraph 22 below) and consider inflation adjustments when the effects of the over-estimate have been fully offset. In this connection, we will discontinue with the current practice of adjusting the standard payment rates according to the forecast inflation for the following year. This is explained in greater detail in the paragraphs below.

Inflation Adjustment in Future

10. Events in the past year have highlighted the problems with the approach adopted so far for adjusting CSSA and SSA standard payments. From a technical point of view, while an index-based adjustment mechanism involving projection could work in concept, it is unable to be followed through completely and faithfully. Notwithstanding the attempt made to produce a more scientifically based SSAIP forecast, there are inherent uncertainties in any forecast, particularly in volatile times. Discrepancies are inevitable and hence the adoption of any forecast methodology must also at the same time allow room for reconciliation when discrepancies do occur. A forecast inflation approach without an acceptable means to deduct any over-provision is bound to create unacceptable financial implications over time.

11. Politically, the community at large, and CSSA/SSA recipients in particular, would find it difficult to appreciate the technical complexities involved. They expect the forecast ought to be accurate and any deviation between the earlier forecast and the subsequent actual outturn would invariably attract criticism that the forecast is “wrong”. This tends to create unnecessary tension in the annual inflation adjustment exercise.

12. While reconciliation of any discrepancies in the light of actual outturn would not erode the originally intended purchasing power, the reality is that those affected, i.e. CSSA/SSA recipients, would find it difficult to understand and accept any reduction to their current rates on grounds of over-provision. In practice, they may have genuine difficulties in having to adjust their expenditure to a reduced level of assistance in dollar terms.

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13. The change in the inflation adjustment mechanism to one based on actual price movements will avoid the above-mentioned problems. It will bring CSSA/SSA inflation adjustments in line with the normal practice of inflation adjustment to a wide range of rates and allowances[2] which are all made to reflect price changes that have already taken place, not in anticipation of changes that would occur.

FINANCIAL IMPLICATIONS

14. Had we implemented a 6.5% reduction in standard rates from 1 August 1999 in accordance with the adjustment mechanism, this would reduce Government expenditure by about $707 million in 1999-2000 ($1,062 million in a full year), broken down as follows –

		$ million
(a)	CSSA standard payment rates	**497**
(b)	SSA standard payment rates	**210**
	Total	**707**

The proposed freeze would mean that we would have to incur this amount that could otherwise be saved and go some way towards relieving the spending pressure of CSSA/SSA. If the money (over $1,000 million a year) were diverted to provide direct services, it could provide over 11 000 residential care and attention places for the elderly or over 13 000 day care places for the elderly. The actual amount of savings forgone in any subsequent year will depend on the inflation rate in that year. A rough estimate based on an assumed modest inflation in the next few years suggests that the total savings forgone would exceed $3,000 million as a result of freezing the rates at their current level until inflation catches up. An amount of this magnitude would be sufficient for building over 30 primary schools.

15. The rapid growth in social security expenditure in recent years, particularly CSSA, remains a concern of the community. CSSA expenditure has increased from $2.4 billion in 1993-94 to $13 billion in 1998-99 (representing an average increase of 31% in real terms every year). It is projected to rise to $15.5

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2 These include pay and allowance adjustments of the civil service, pension increases for retired civil servants, honorarium and allowances for Members of the Legislative Council and Provisional District Boards, grants and loans for students under the various financial assistance schemes, subsidy for kindergartens, ex gratia payments for land clearances, emergency relief grants and asset limits under the CSSA Scheme.

billion in 1999-2000, which is 8.6% of total Government recurrent expenditure. Together with an estimated expenditure of $4.9 billion on SSA, cash payments under the social security schemes now account for 11.4% of total Government recurrent expenditure. The current proposal not to bring down the rates to reflect the over-projection on compassionate grounds and its consequential impact on CSSA/SSA expenditure in the following years until inflation catches up will create added pressure in this area of spending.

16. In view of the current economic downturn and rising unemployment, CSSA will continue to perform its safety net function to support those in need. However, we have to look at all aspects of the CSSA Scheme and its administration to ensure equity in the use of limited public resources. The Social Welfare Department has started to implement a Support for Self-reliance Scheme since June 1999. The aim is to encourage and assist those CSSA recipients who are able to work to actively seek work and become self-reliant. The Department will also step up fraud prevention efforts to ensure that financial assistance is targeted at those genuinely in need. We will need to sustain our efforts in these and other areas concerning the CSSA Scheme.

CONSULTATION

17. We consulted the Legislative Council Welfare Panel at its meetings on 14 June and 2 July 1999. While Members welcome the freezing of the rates at their prevailing levels until inflation in subsequent years catches up, they expressed concern over the discontinuation of the forecast methodology. Some Members are particularly worried that the adoption of an adjustment mechanism based on actual price movements would put CSSA recipients in a vulnerable position at times of high inflation.

18. As we have explained to the Panel, the current forecast inflation methodology for adjusting social security payments was introduced in 1989 at a time when the standard payment rates under the social security schemes were low, inflation was high and the impact of social security payments on overall Government expenditure was relatively more manageable. The prevailing circumstances are very different.

19. Over the years, Government has made considerable improvements to the level of assistance under the CSSA Scheme. For example, the standard rate for an able-bodied single adult was $620 in 1989 and is now $1,805. This represents an increase of 191% as compared to inflation over the period of only 117%. Even more significant improvements have been made in respect of the

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standard rates for CSSA elderly and child recipients. It is therefore arguable whether CSSA recipients are now placed in the same disadvantageous position that require extra protection against price increases by increasing their payments ahead of time based on forecast inflation.

20. As can be seen from the actual SSAIP movements in Enclosure 1, inflation was raging at a high level of close to 10% in the early years when we adopted the forecast inflation methodology. This was the case in 1989 and well into the early 1990s. But consumer price inflation has distinctly eased in 1998 and turned negative this year. It should be noted that for the purpose of Government's Medium Range Forecast to 2002-03, the assumed year-on-year inflation has been moderated to 3%.

21. From a fiscal point of view, standard payments under the CSSA and SSA Schemes now account for about $16 billion of Government recurrent expenditure (the rest is accounted for by special grants payments under the CSSA Scheme). Every 1% of over-estimate, payable in advance, that could not be made up for subsequently would mean that we had to spend $160 million more a year. In the light of the public spending constraints we now face and the need to deploy limited resources to achieve policy priorities, we do not feel that inflation adjustments based on a mechanical formula without due regard to the overall economical and fiscal situation are justified.

THE ADMINISTRATION'S RESPONSE

22. The above said, we fully appreciate Members' concern for CSSA recipients at times of high inflation. To address this concern, the Administration will –

(a) put in place an internal procedure to monitor and review the actual SSAIP movement on a half-yearly basis;

(b) if recent SSAIP rates and the economic variables that may affect its future movement point to a likely high inflation (say of a magnitude similar to that experienced in the early years of adopting the forecast methodology), consider seeking approval for inflation adjustments to the standard payments ahead of the annual cycle; and

(c) in the intervening years when the rates will remain frozen, submit an Information Note on an annual basis to FC to facilitate its monitoring of this adjustment exercise.

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BACKGROUND INFORMATION

23. The social security system administered by the Social Welfare Department comprises two schemes: the CSSA Scheme and the SSA Scheme.
Encl. 2 An explanatory note is at Enclosure 2.

Finance Bureau/Health and Welfare Bureau
July 1999

Enclosure 1 to FCRI(1999-2000)6

Annual inflation adjustment for CSSA and SSA Standard payment rates

Financial year	SSAIP forecast increase for the year (A)	Adjustment to account for over-projection/ under-projection in the previous year (B)	Increase in standard payment rates approved by FC (C)=(A)+(B)	Actual SSAIP movement for the year (D)	Actual SSAIP movement vis-à-vis forecast (under-projection in negative) (E)=(A)-(D)
1989-90	8%	+3%	11%	9.8%	-1.8%
1990-91	8%	+1.8%	10%*	8.1%	-0.1%
1991-92	9%	0	9%	10.3%	-1.3%
1992-93	9.5%	+1.3%	10.74%*	8.3%	1.2%
1993-94	9%	0	9%	7.7%	1.3%
1994-95	7.7%	0	7.7%	7.1%	0.6%
1995-96	8.5%	0	8.5%	6.2%	2.3%
1996-97	7%	0	7%	3.4%	3.6%
1997-98	6.5%	0	6.5%	5%	1.5%
1998-99	4.8%	The 1.5% over-projection in the previous year to be off-set by deferring the next adjustment date for four months	4.8%	-0.2%	5.0%

* These are due to rounding effect of the rate increase.

Social Security System

Introduction

The social security system provides a safety net for individuals or families suffering financial hardship for various reasons, such as old age, disability, illness, unemployment, low earnings, etc. The aim of the Comprehensive Social Security Assistance (CSSA) Scheme is to assist such individuals or families in meeting basic and essential needs of livelihood. The aim of the Social Security Allowance (SSA) Scheme is to help the severely disabled and the elderly to meet the special needs arising from disability or old age. A person can receive either assistance under the CSSA Scheme or one of the allowances under the SSA Scheme.

Eligibility

2. Both schemes are non-contributory. The CSSA Scheme is means-tested. Applicants for SSA are not subject to means test except that persons aged between 65 and 69 applying for the Old Age Allowance have to declare that their income and assets do not exceed the prescribed levels.

3. There are residence requirements for both Schemes. In addition, applicants for CSSA aged between 15 and 59, if unemployed and in normal health, are expected to seek work actively and report their employment condition to staff of the Social Welfare Department regularly with effect from 1 June 1999.

4. Starting from 1 April 1997, elderly persons aged 60 or above, who have been in receipt of CSSA continuously for three years, may join the Portable CSSA Scheme whereby they are allowed to continue to receive their monthly standard payments and annual long-term supplement should they choose to retire permanently in Guangdong.

Comprehensive Social Security Assistance Scheme

5. The amount of assistance is determined by the resources and needs of the applicant. The difference between the applicant’s income and his total recognized needs as determined by reference to certain prescribed levels, will be the amount of assistance payable.

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6. The Scheme embraces different standard payments to meet the basic and essential needs of broad categories of recipients. In addition, starting from 1 June 1999, an annual long-term supplement is payable only to those elderly, disabled and ill-health recipients who have been receiving assistance continuously for more than 12 months for the replacement of household and durable goods. A monthly supplement is also paid to single parents in recognition of the special difficulties they face in bringing up families on their own without the support of spouses. Apart from these standard payments, a wide range of special grants are payable to meet the specific needs of an individual or family. They include payments to cover such expenses as rent, water charges, school fees, child care centre fees and burial grants.

Social Security Allowance Scheme

7. Four allowances are payable under this scheme as follows -

(a) Normal Disability Allowance

For severely disabled persons who, broadly speaking, suffer from a 100% loss of earning capacity, or who are profoundly deaf.

(b) Higher Disability Allowance

For severely disabled persons who require constant attendance from others in their daily life but are not receiving such care in a government or subvented institution or a medical institution under the Hospital Authority.

(c) Normal Old Age Allowance

For persons aged between 65 and 69 whose income and assets do not exceed the prescribed levels.

(d) Higher Old Age Allowance

For persons aged 70 or above.