

# Research Brief

Issue No. 3  
2016 – 2017



Research Office  
Legislative Council Secretariat

## The 2017-2018 Budget

March 2017

*Fiscal landscape in Hong Kong has stayed broadly the same over the past two decades. While there are concerns over the "narrow tax base" and "volatile revenue sources", Hong Kong manages to achieve fiscal surplus for 13 consecutive years since 2004-2005.*

*Hong Kong is renowned for its fiscal discipline, but there are public concerns over service gaps in certain policy areas. For example, there are long queues for public rental housing, medical services and social welfare services. Moreover, there are insufficient places in publicly-funded universities for secondary school leavers meeting the entrance requirements.*

*Fiscal surplus has accumulated by a total of HK\$561 billion over the past two decades, against conservative budget forecasts. About half of the fiscal surplus over the past 10 years has been returned to the community through one-off relief measures. While two-thirds of this relief were for tax refunds, 16% was for assistance of grassroots families.*

*Fiscal reserves hit a record high of HK\$936 billion in March 2017, but investment yield from this enlarging asset base has fallen steadily from 9.4% to 3.3% in recent years, resulting in a smaller contribution of investment income to overall government revenue.*

*The Council will resume the Second Reading debate on the Appropriation Bill 2017 at its meeting of 12 April 2017.*

### 1. Introduction

1.1 Hong Kong is renowned for its fiscal discipline. Amongst the 35 places classified as advanced economies by the International Monetary Fund ("IMF"), Hong Kong is the only place attaining fiscal surplus throughout the past decade during 2007-2016.<sup>1</sup> In the most recent Budget, the Financial Secretary forecasts a fiscal surplus of HK\$16.3 billion in 2017-2018, stretching the surplus record for another year. Moreover, the accumulated fiscal reserves reaches a record high of HK\$936 billion in March 2017, equivalent to 24 months of government expenditure.<sup>2</sup> As the year of 2017 marks the 20<sup>th</sup> anniversary of reunification of Hong Kong with the Mainland, it may be a timely occasion to review the composition of local public finance and its implications for Hong Kong. This brief summarizes the major findings.

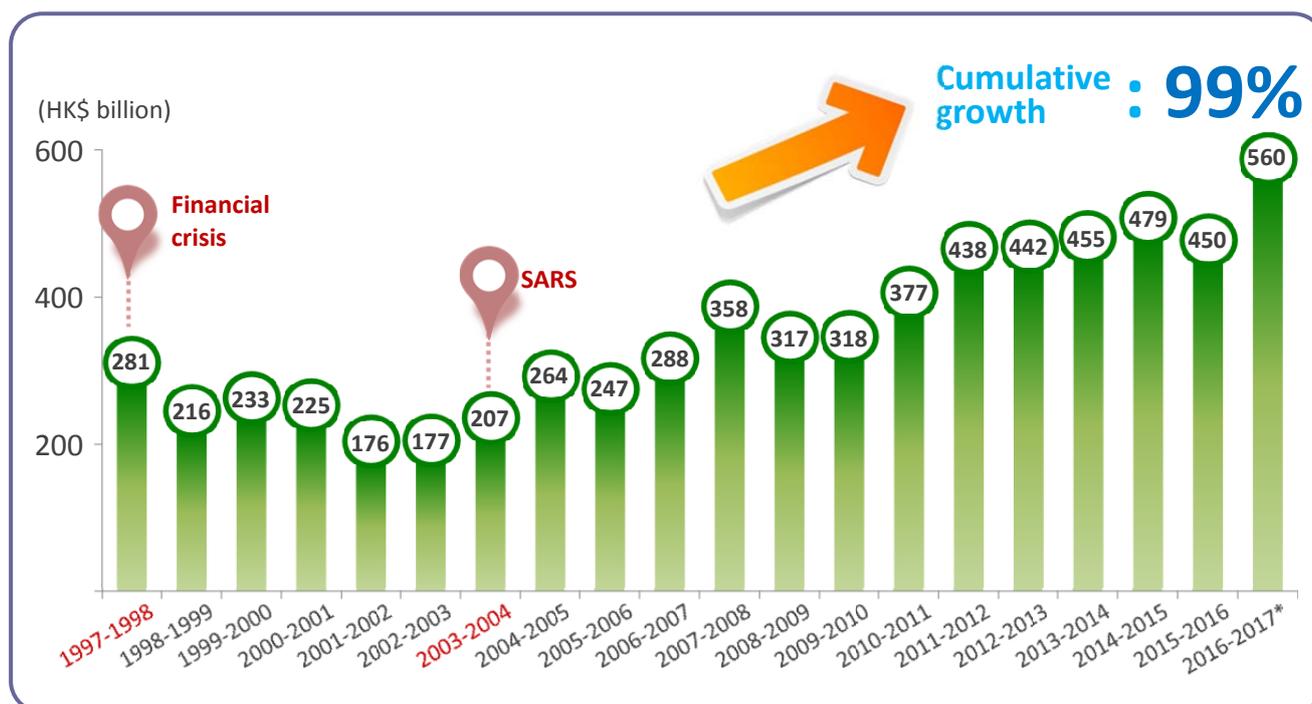
<sup>1</sup> These 35 advanced economies include the United States, Germany, Japan, Switzerland and Sweden. Taken together, they had a combined fiscal deficit in each and every year during the past decade 2007-2016, averaging at 1.2%-8.8% of their combined national income. See International Monetary Fund (2016), Department of Statistics Singapore (2016) and Organisation for Economic Co-operation and Development (2017).

<sup>2</sup> The stock of fiscal reserves in March 2017 does not include the investment income of HK\$27.5 billion in 2014 and HK\$45.2 billion in 2015, which was set aside and retained within the Exchange Fund for injection into the Housing Reserve.

## 2. Structure of government revenue

2.1 Over the past two decades, overall government revenue has increased by a cumulative 99% to HK\$560 billion in 2016-2017<sup>3</sup>, although greater volatility was seen in the first decade amidst the outbreaks of Asian financial crisis in 1997 and Severe Acute Respiratory Syndrome ("SARS") in 2003 (Figure 1).

Figure 1 – Government revenue, 1997-1998 to 2016-2017\*



Note: (\*) Revised estimate.

Data sources: Budget speech, various years.

2.2 A composition analysis of major revenue sources gives rise to the following findings:

- (a) **Profits tax as the largest revenue contributor most of the time:** Not only is profits tax the largest contributor to the public coffers during most of the past two decades, its share in overall revenue has gone up visibly from 20% in 1997-1998 to 25% in 2016-2017.<sup>4</sup> Coupled with a 67% rise in the number of tax-paying companies in 17 years or so, this

<sup>3</sup> This is the revised estimate only, based on actual figures available for the first nine months of 2016-2017. The Government is scheduled to release the provisional actual figures at end-April 2017, incorporating the actual figures for the last three months of 2016-2017 as well. Based on the past pattern in the earlier years, the provisional actual figures of both government revenue and fiscal balance are usually higher than the revised estimate made in February.

<sup>4</sup> Contribution of profits tax to overall government revenue had once fallen to a low of 16% in 1999-2000, but hit a high of 31% in 2015-2016, the highest level over the past three decades or so.

shows that Hong Kong is still a good place for doing business in the region.<sup>5</sup>

- (b) **Salaries tax as stabilizing revenue source during cyclically economic downturn:** Salaries tax is now the third revenue contributor, taking up 11% of overall government revenue at both ends of the past two decades. While the number of taxpayers increased moderately by just 35% in 17 years during 1997-2014, the relative importance of salaries tax as an income source shot up at times of business recession, as shown in its rise to 17% in 2002-2003 when other government revenues were severely hit by the deflation by then.
- (c) **Land premium as the second largest revenue contributor with great volatility:** Land premium was the largest revenue contributor in 1997-1998 and the second largest in 2016-2017, with a high revenue share of 21%-22% in both years. Yet revenue from land premium is highly volatile, with its revenue share slumping to only 3% amidst the property downturn in 2003-2004.
- (d) **Stamp duties and general rates as another volatile income sources:** Stamp duties also hinge on property market developments, with its revenue share ranging widely from two extremes of 4% and 16% over the past 20 years. It stayed at 10% in both 1997-1998 and 2016-2017. By a similar token, revenue from general rates which taxes properties also varies with property market developments, with its share of revenue contribution doubling from 2% in 1997-1998 to 4% in 2016-2017.

The three property-related items (i.e. land premium, stamp duties and rates) took up 35.2% of overall government revenue in 2016-2017, slightly higher than that of 34.8% in 1997-1998.

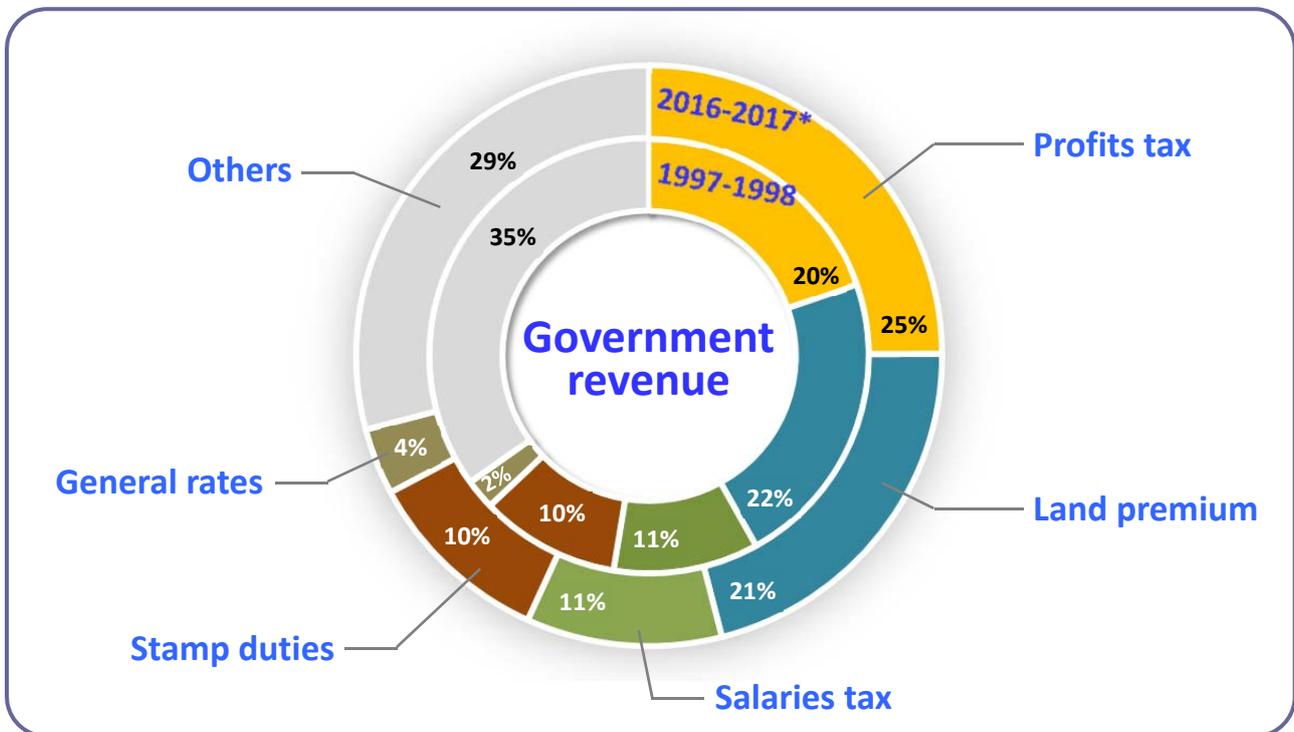
- (e) **Five major items taking up 71% of overall revenue:** As a whole, the above five major items accounted for a lion's share of 71% in total government revenue in 2016-2017, up from 65% in 1997-1998 (**Figure 2**). Yet the combined share of these five items had once fallen to a trough of only 48% in 1998-1999. In spite of repeated warnings against excessive reliance on these "particularly volatile sources", these five items have remained the key sources of government revenue over the past two decades, as the Government

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<sup>5</sup> The number of tax-paying companies went up from 60 500 in 1997-1998 to 100 900 in 2014-2015. See Financial Services and the Treasury Bureau (2014) and GovHK (2016).

has not introduced any specific measures to diversify revenue sources.<sup>6</sup>

**Figure 2 – Percentage share of major government revenue items in 1997-1998 and 2016-2017\***



Note: (\*) Revised estimate.  
Data sources: Budget speech, various years.

2.3 In the 2017-2018 Budget, the Government announces that it will set up a "tax policy unit" to address a number of taxation issues, including the "problem of a narrow tax base" in Hong Kong.<sup>7</sup> This will be another round of tax policy review, after the last public consultation on tax reform and proposed introduction of Goods and Services Tax ("GST") conducted in July 2006.<sup>8</sup> In that exercise, the Government concluded that "there was insufficient public support nor were the conditions right for the introduction of GST", as the public was concerned about (a) the regressive nature of GST; (b) adverse effect on public consumption and tourist spending; and (c) adverse implications on the competitiveness of the local economy.<sup>9</sup>

<sup>6</sup> See the 1997-1998 Budget and Financial Services and the Treasury Bureau (2014).

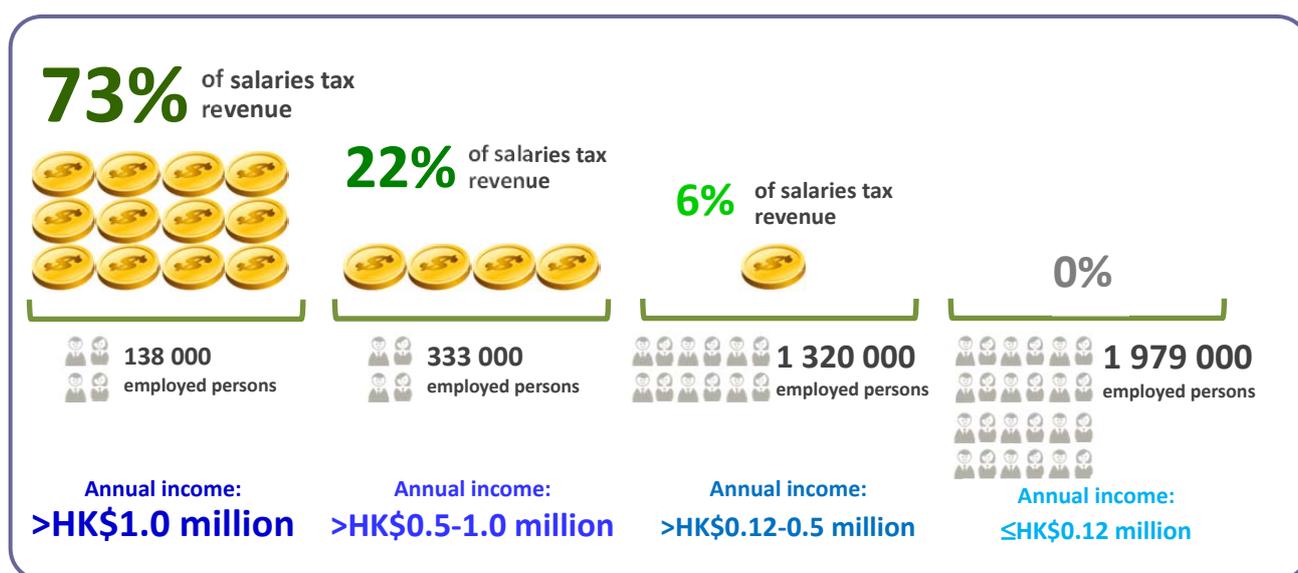
<sup>7</sup> The tax policy unit will be set up within the Financial Services and the Treasury Bureau to (a) align tax practice in Hong Kong with global standards; (b) study ways to foster pillar industries and emerging industries with tax incentives; and (c) explore broadening the tax base and increasing revenue for sustainable development of the Hong Kong society. See 2017-2018 Budget, pp. 18-19.

<sup>8</sup> On 18 July 2006, the Government issued the public consultation document entitled "Broadening the Tax Base, Ensuring our Future Prosperity: What's the Best Option for Hong Kong?", putting forward the idea of GST to widen the tax base. After nine-month consultation, the Government issued the Final Report in June 2007.

<sup>9</sup> See Financial Services and the Treasury Bureau (2007).

2.4 This apart, the Government has reiterated its concerns over "narrow salaries tax base"<sup>10</sup> (Figure 3) and "narrow profits tax base"<sup>11</sup> (Figure 4) in its earlier Budget consultation. It is not clear at this juncture whether they are the targets of the upcoming taxation policy review. Nevertheless, in view of the fact that broadly half of the local workforce who did not pay salaries tax largely earned less than HK\$10,000 per month in 2014-2015, any additional tax revenue from these low-income earners could be quite limited.<sup>12</sup> Likewise, as about 57% of the tax-paying business firms made annual profits of less than HK\$0.5 million in 2014-2015, it is not clear how much additional tax revenue can be generated from these small to medium-sized enterprises. In the attempt to widen the tax net, the Government may also need to balance it against the ability-to-pay and efficiency principles as well, both are the cornerstones of a sound tax system.<sup>13</sup>

**Figure 3 – Distribution of salaries tax by annual income of employed population\* in 2014-2015**



Note: (\*) In 2014-2015, the working population was 3.77 million in Hong Kong, within which 1.98 million or 52% needed not pay any salaries tax.

Data source: GovHK (2016).

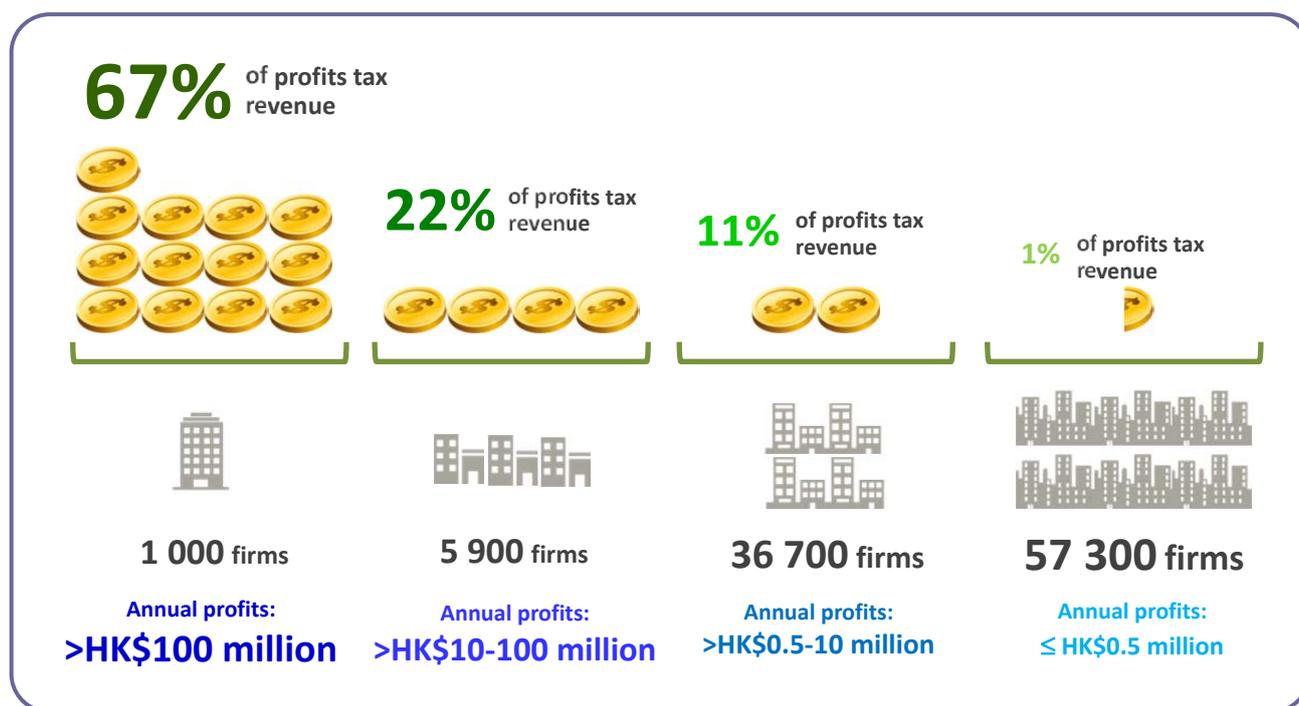
<sup>10</sup> In 2014-2015, 52% of the working population needed not pay any salaries tax, while the top 5% of tax payers contributed 63% of salaries tax revenue. See p. 25 of GovHK (2016).

<sup>11</sup> In 2014-2015, 91% of registered corporations needed not pay any profits tax, while the top 5% of corporations contributed 86% of profits tax revenue. See p. 26 of GovHK (2016).

<sup>12</sup> These are administrative statistics compiled by the Inland Revenue Department. See GovHK (2016).

<sup>13</sup> While the taxpayers should be able to afford the tax under the ability-to-pay principle, the administrative cost should be low relative to the tax revenue generated under the efficiency principle.

**Figure 4 – Distribution of profits tax by annual assessable profits of business firms\* in 2014-2015**



Note: (\*) In 2014-2015, there were about 1.15 million registered corporations in Hong Kong, within which 1.05 million or 91% needed not pay any profits tax.

Data source: GovHK (2016).

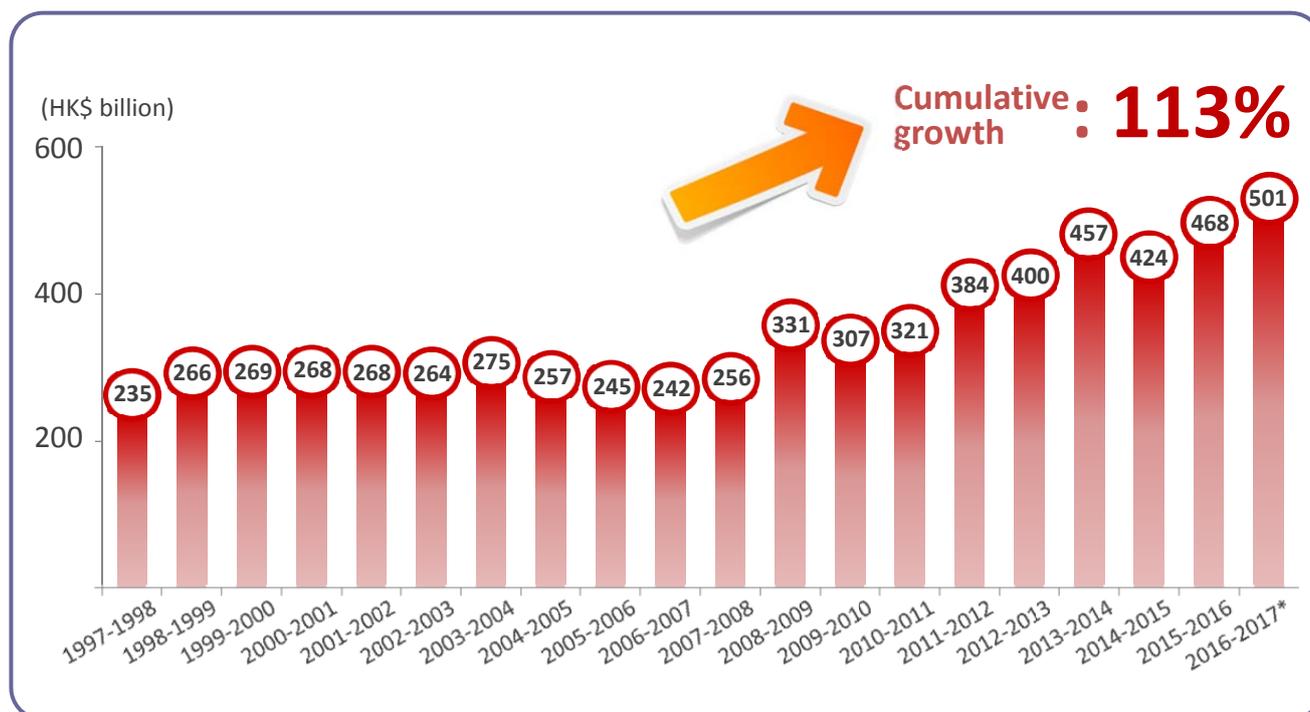
### 3. Structure of public expenditure

3.1 Government expenditure has increased by a cumulative 140% in 20 years to HK\$467 billion in 2016-2017, faster than the 99% growth in government revenue and overall consumer price inflation of 25%.<sup>14</sup> Taking into account the expenditure of other public bodies as well, overall public expenditure has gone up by 113% to HK\$501 billion over the same period (Figure 5).<sup>15</sup>

<sup>14</sup> According to the assessment of the Government, services for education, social welfare and healthcare had been enhanced at an average annual rate of 3% in real terms since 1997-1998, after adjustment for demographic and price changes. See Financial Services and the Treasury Bureau (2014).

<sup>15</sup> Public expenditure comprises government expenditure and expenditure by other public bodies. It does not include expenditure by those organisations in which the government has only an equity position, such as the Airport Authority and the MTR Corporation Limited.

**Figure 5 – Public expenditure<sup>#</sup>, 1997-1998 to 2016-2017\***



Notes: <sup>(#)</sup> Public expenditure is the sum of government expenditure and expenditure of other public bodies.

<sup>(\*)</sup> Revised estimate.

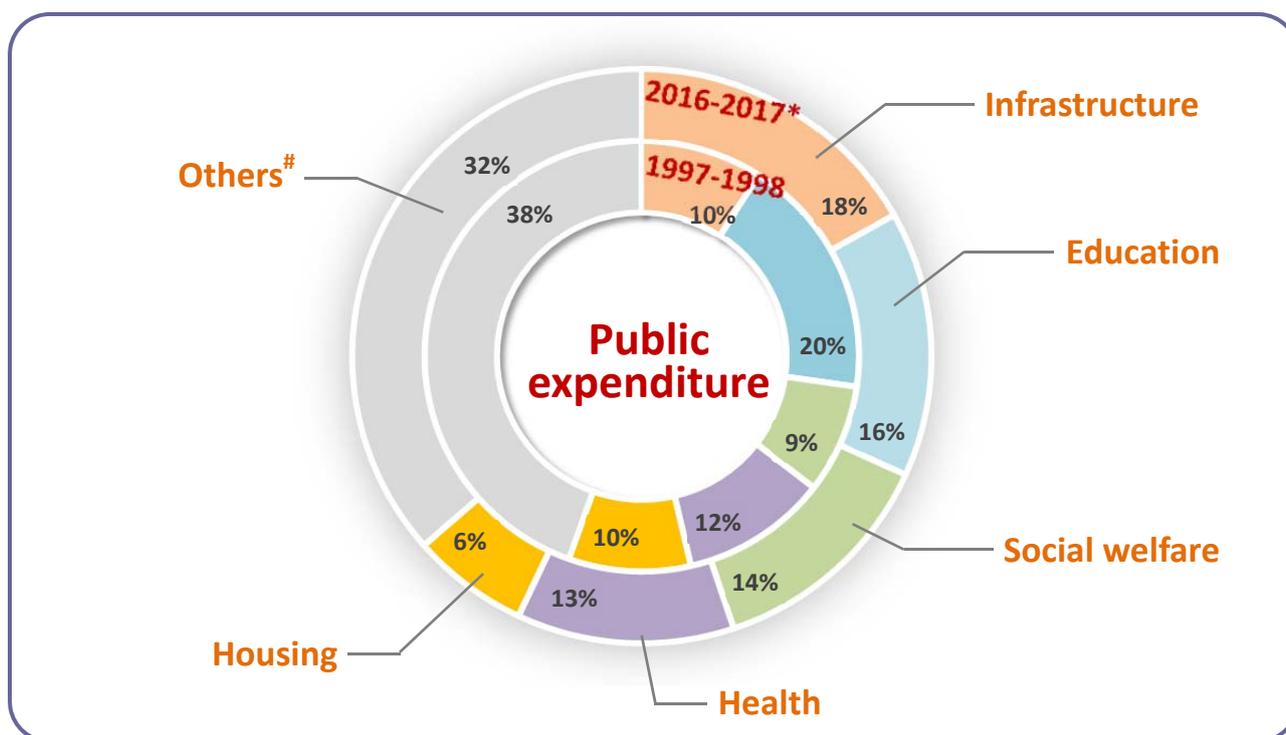
Data sources: Budget speech, various years.

3.2 Analyzed by major policy area, a structural analysis of public expenditure comes up with the following findings:

- (a) **Infrastructure emerging as the largest expenditure item:** As a result of heavy investment in a number of civil engineering projects especially in massive transport projects, infrastructure expenditure has registered a cumulative growth of 291% over the past two decades to HK\$93 billion in 2016-2017.<sup>16</sup> Infrastructure has thus overtaken other expenditure items to become the largest expenditure item, with its share in public expenditure almost doubling from 10% in 1997-1998 to 18% in 2016-2017 (**Figure 6**).

<sup>16</sup> For instance, those infrastructural projects still under intensive construction in early 2017 include Hong Kong – Zhuhai-Macao Bridge, Hong Kong Section of Guangzhou-Shenzhen-Hong Kong Express Rail Link, West Kowloon Cultural Project, Kai Tak Development and redevelopment of Kwong Wah Hospital and Kwai Chung Hospital.

**Figure 6 – Percentage share in overall public expenditure by major policy area in 1997-1998 and 2016-2017\***



Note: (\*) Revised estimate.

(<sup>#</sup>) Other policy areas comprise community and external affairs, economic, security, environment and food.

Data sources: Budget speech, various years.

- (b) **Education as the second largest expenditure item:** Education expenditure has risen by a total of 73% over the past two decades to HK\$83 billion in 2016-2017, along with service enhancements from kindergarten to post-secondary education.<sup>17</sup> However, this was still far behind the corresponding growth of the neighbouring economies over the same period, including 228% for South Korea, 183% for Singapore and 115% for Taiwan.<sup>18</sup> To a certain extent, this slow growth was attributable in part to the 10% shrinkage in student population amidst the ageing trend in society.<sup>19</sup> As education expenditure lagged behind overall growth in public expenditure, the share of education in overall public spending has eased back from 20% to 16% over the past two decades. Education is now the second largest expenditure item, receding from the top position in 1997-1998.

<sup>17</sup> New initiatives in education in recent years included launching Pre-primary Education Voucher Scheme in 2007-2008, free senior secondary education in 2008-2009 and new curriculum for senior secondary education in 2009-2010, small class teaching in primary schools in 2009-2010, four-year tertiary education in 2012-2013, and free kindergarten education in 2017-2018. For details, see Financial Services and the Treasury Bureau (2014).

<sup>18</sup> See Asian Development Bank (2016).

<sup>19</sup> In 2015, it was estimated that there were some 1.1 million students pursuing education from kindergarten to tertiary institutions, about 10% fewer than those of 1.2 million in 2000.

- (c) **Social welfare payments recording rapid growth:** Total expenditure on social welfare has experienced a cumulative growth of 221% in 20 years to HK\$68 billion in 2016-2017, lifting its expenditure share noticeably from 9% to 14%. Transfer payments in terms of social security payments take up about two-thirds of the overall welfare budget. More specifically, non-means tested cash payments in the form of Social Security Allowance ("SSA") registered the fastest growth, mainly attributable to introduction of Old Age Living Allowance ("OALA") in 2013.<sup>20</sup> The share of SSA in overall public expenditure has thus doubled from 2% to 4%. As to the means-tested Comprehensive Social Security Assistance Scheme ("CSSA"), its expenditure share held broadly stable at around 4%.<sup>21</sup>

For the rest of the one-third of the welfare budget, they are mostly welfare services in kind (e.g. elderly services, rehabilitation services, and family and child services).<sup>22</sup> Welfare services in kind took up about 5% of public expenditure in 2016-2017, up from 3% in 1997-1998.

- (d) **Health expenditure recording moderate expansion:** Over the past two decades, health expenditure has gone up by a total of 137% to HK\$66 billion in 2016-2017, upon certain service enhancements.<sup>23</sup> Most the health expenditure is for subvention of the Hospital Authority, mainly to meet rising staff cost and drug cost. While the expenditure share of health has edged up from 12% to 13% in two decades, its relative position in public expenditure has receded from the second to the fourth position.

- (e) **Housing expenditure recording slowest growth:** Public expenditure on housing has increased by only 25% to HK\$30 billion in 2016-2017. This was the slowest increase amongst the 10 policy areas, partly due

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<sup>20</sup> Over the past two decades, expenditure on SSA has increased by a total of 402% to HK\$22.2 billion in 2016-2017, mainly due to the launch of OALA in 2013. Between 1997-1998 and 2015-2016, there was a 56% increase in the number of SSA cases, while the average monthly expenditure on each SSA case went up by 214% over the same period.

<sup>21</sup> Expenditure on CSSA has increased by a total of 137% in 20 years to HK\$22.4 billion in 2016-2017. Between 1997-1998 and 2015-2016, there were 24% increase in the number of CSSA cases and 90% rise in average monthly expenditure on each CSSA case.

<sup>22</sup> Other welfare services have increased by about 219% in 20 years to HK\$23.8 billion in 2016-2017. Major initiatives in recent years included the launch of Public Transport Fare Concession Scheme for the elderly and persons with disabilities and providing greater hospital discharge support services for the elderly.

<sup>23</sup> Enhancements in health services include opening 980 additional general hospital beds after 2009-2010, introducing community-based recovery support programme for discharged mentally ill patients since 2009-2010, widening the scope of new drugs since 2009-2010, and introducing the Elderly Health Care Voucher Pilot Scheme since 2008-2009.

to fewer newly completed flats in public rental housing.<sup>24</sup> As such, the expenditure share of housing has fallen visibly from 10% to 6% over the past two decades.

- (f) **Five major items taking up 68% of overall expenditure:** Taken together, the above five major expenditure items took up 68% of total public expenditure in 2016-2017, up from 62% in 1997-1998.

3.3 In spite of the aforementioned service enhancements, there are still public concerns over certain service gaps in various policy areas. As an illustration, it is noted that there were some 150 000 general households (excluding non-elderly singleton households) waiting for **public rental housing** at end-2016, with an average waiting time lengthened to 4.7 years, exceeding the target waiting time of three years. In **education**, some 13 500 or 52% of secondary school leavers meeting the entrance requirements cannot pursue the undergraduate studies at the publicly-funded universities in 2015-2016. In **medical and health**, the waiting time for new routine cases of some out-patient specialist services in public hospitals has been lengthened up to two years at end-2016. While the average waiting time for semi-urgent cases of accident and emergency services increased from 76 minutes to 107 minutes in five years ending 2015-2016, that for non-urgent cases also lengthened from 103 minutes to 130 minutes in general.<sup>25</sup> In **social welfare**, some 33 000 elderly persons aged 65 and above were waiting for subsidized residential care services at end-2015, with an average waiting time of 20-26 months. About one-fifth of them (i.e. 5 900 persons) passed away while waiting for such services.<sup>26</sup>

3.4 Moreover, there was a general pattern for the Government to spend less than that was budgeted in each year over the past two decades, averaging at about HK\$17 billion or 5% of actual expenditure per annum. Analyzed by policy area, "Support" was the largest under-spending item, accounting for 32% of the total, followed by education (16%), social welfare (14%) and housing (14%). While under-spending in "Support" can be attributable to the huge sum set aside as contingency funds, it is not clear why such under-spending is seen in other policy areas, in the absence of detailed information from the Government (**Figure 7**).<sup>27</sup>

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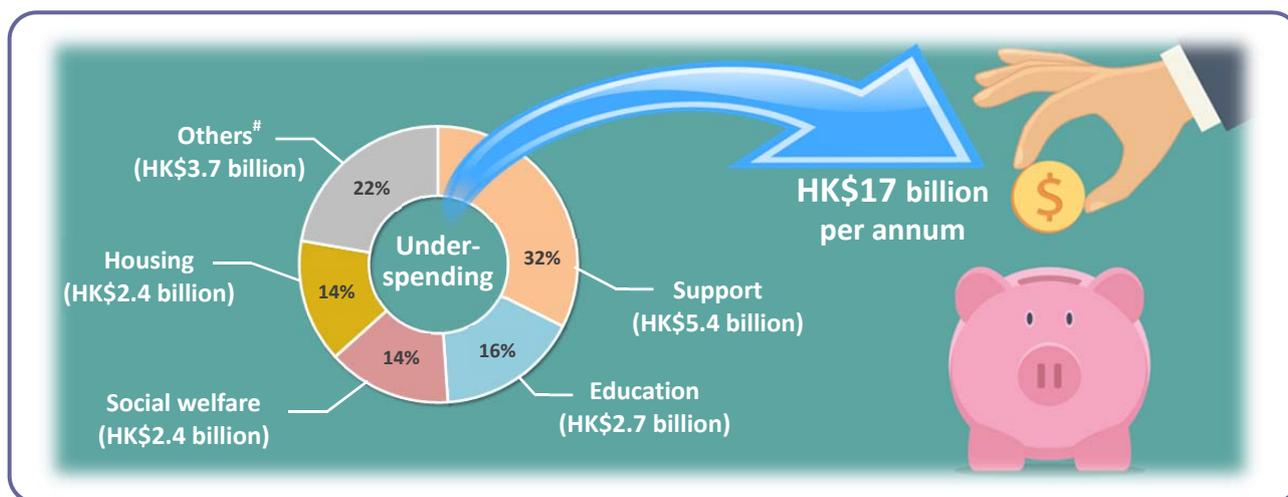
<sup>24</sup> Between 1997-1998 and 2015-2016, the annual number of newly completed flats in public rental housing fell from 17 900 to 14 300.

<sup>25</sup> The longest average waiting time for non-urgent cases of accident and emergency services recorded in a hospital was 227 minutes. See Legislative Council Secretariat (2016b).

<sup>26</sup> See Legislative Council Secretariat (2016a), (2016b), (2016c) and (2017).

<sup>27</sup> "Support" covers those supportive services required in central management of civil service, revenue collection and financial control, intra-government services, support to Members of the Legislative Council, etc. According to the Treasury, a lump sum amount was put in "Support" to cater for funding initiatives under planning and unanticipated increase in expenditure in other policy areas. It acts more or less as contingency funds.

**Figure 7 – Discrepancy between budgeted and actual public expenditure by key policy area, annual average between 1997-1998 and 2016-2017\***



Notes: (\*) Revised estimate.

(<sup>#</sup>) Other policy areas comprise community and external affairs, economic, infrastructure, security, environment and food and health.

Data sources: Budget speech, various years.

#### 4. Fiscal surplus and one-off relief

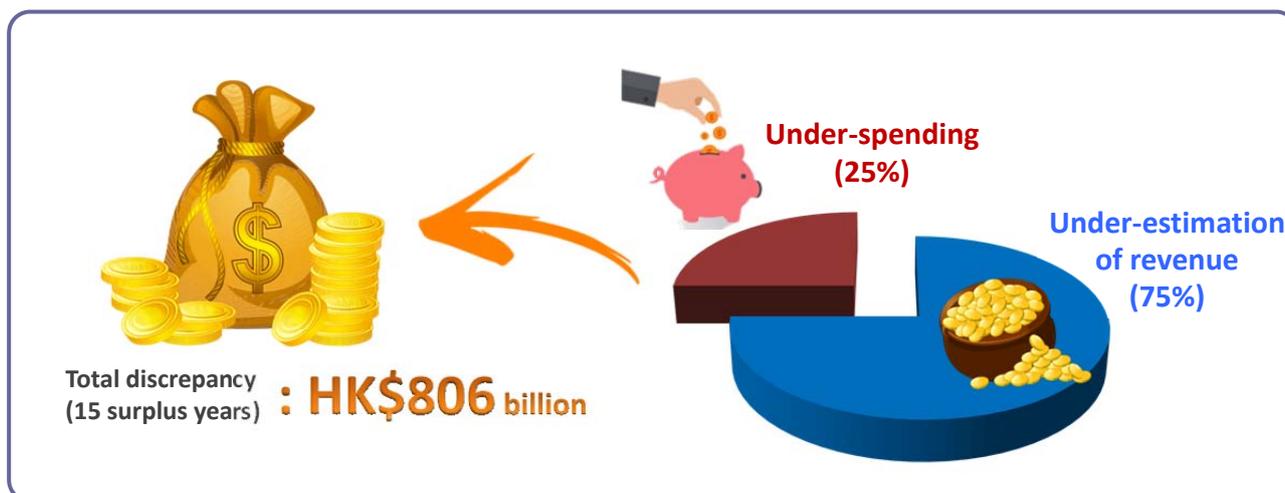
4.1 For the 20 years after reunification, the Government attained fiscal surplus in 15 years totaling at HK\$757 billion, far more than the combined deficit of HK\$196 billion seen in the other five years.<sup>28</sup> For those surplus years, the various Financial Secretaries had originally made a conservative forecast of combined deficit of HK\$49 billion. Upon closer analysis, 75% of the projection discrepancy in these 15 surplus years was attributable to "under-estimation of revenue", and the rest of 25% to the aforementioned "under-spending" (**Figure 8**).<sup>29</sup> Even IMF was concerned about the economic implications of the "conservative forecasts", "over-achievement of revenues" and "underachievement of expenditures" of the Government in its most recent report about Hong Kong.<sup>30</sup>

<sup>28</sup> Fiscal deficit was seen in 1998-1999 and four years in a row during 2000-2001 and 2003-2004.

<sup>29</sup> For these 15 surplus years, there was an under-estimation of government revenue totalling HK\$607 billion and an over-estimation of government expenditure amounting to HK\$199 billion. They accounted for 75% and 25% of the projection discrepancy in fiscal balance accordingly.

<sup>30</sup> See International Monetary Fund (2017).

**Figure 8 – Total discrepancy between budget forecast and actual outturn on fiscal balance for the 15 surplus years\***



Note: (\*) During the past two decades, all except 1998-1999 and 2000-2004 were surplus years.  
Data sources: Budget speech, various years.

4.2 In the light of fiscal surplus in the preceding year, it has become a common practice for the Government to set aside certain resources for offering one-off relief to the general public in their Budget next year since 2007-2008.<sup>31</sup> For the past decade as a whole, it is estimated that such one-off relief amounted to HK\$320 billion, or 56% of the total fiscal surplus.<sup>32</sup> Within this one-off relief, its usage can be broadly grouped into four major categories:

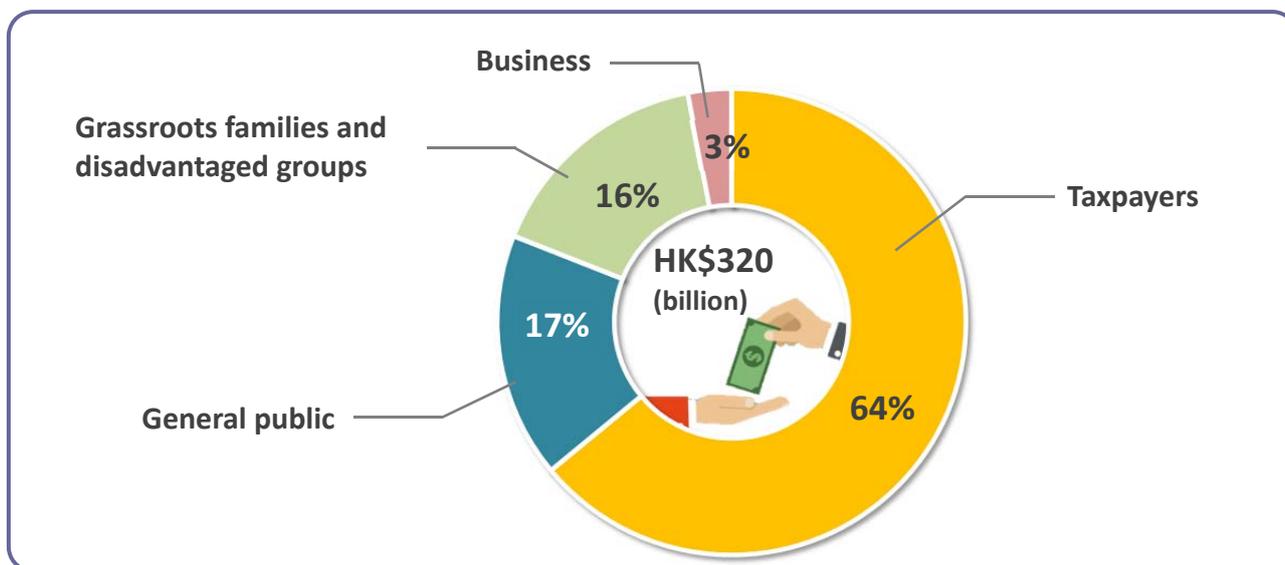
- (a) **Tax refunds:** The majority (64%) of one-off relief is essentially tax refunds, i.e. returning the surplus revenue to payers of salaries tax, profits tax and rates (**Figure 9**).
- (b) **Universal subsidy:** About 17% of the one-off relief is for the benefits of all citizens, including cash payment of HK\$6,000 to every adult in 2011-2012 and universal subsidy of electricity charges in four of the five years between 2008-2009 and 2013-2014.
- (c) **Assisting grassroots families and disadvantaged groups:** About 16% of the relief is for assisting grassroots families, including waiving rental payments of tenants in public rental housing, granting extra payments to CSSA and SSA recipients.
- (d) **Assisting business:** The rest of 3% is mostly used for assisting businesses by exempting annual business registration fees.

<sup>31</sup> For the first decade before 2007-2008, the Government was suffering from fiscal deficit and there was not much resource left for one-off relief.

<sup>32</sup> For the second decade between 2007-2008 and 2016-2017, there was a total fiscal surplus of HK\$566 billion, while the respective amount of one-off relief offered in the next fiscal years totalled at HK\$320 billion.

4.3 Against this backdrop, one-off relief can be conceived as serving multiple functions. While it is essentially a return of the extra resources back to community through tax refunds, a part of it is also used as an income redistribution tool for assisting grassroots families.

**Figure 9 – Distribution of one-off relief by recipient over the past decade**



Data sources: Budget speech, various years.

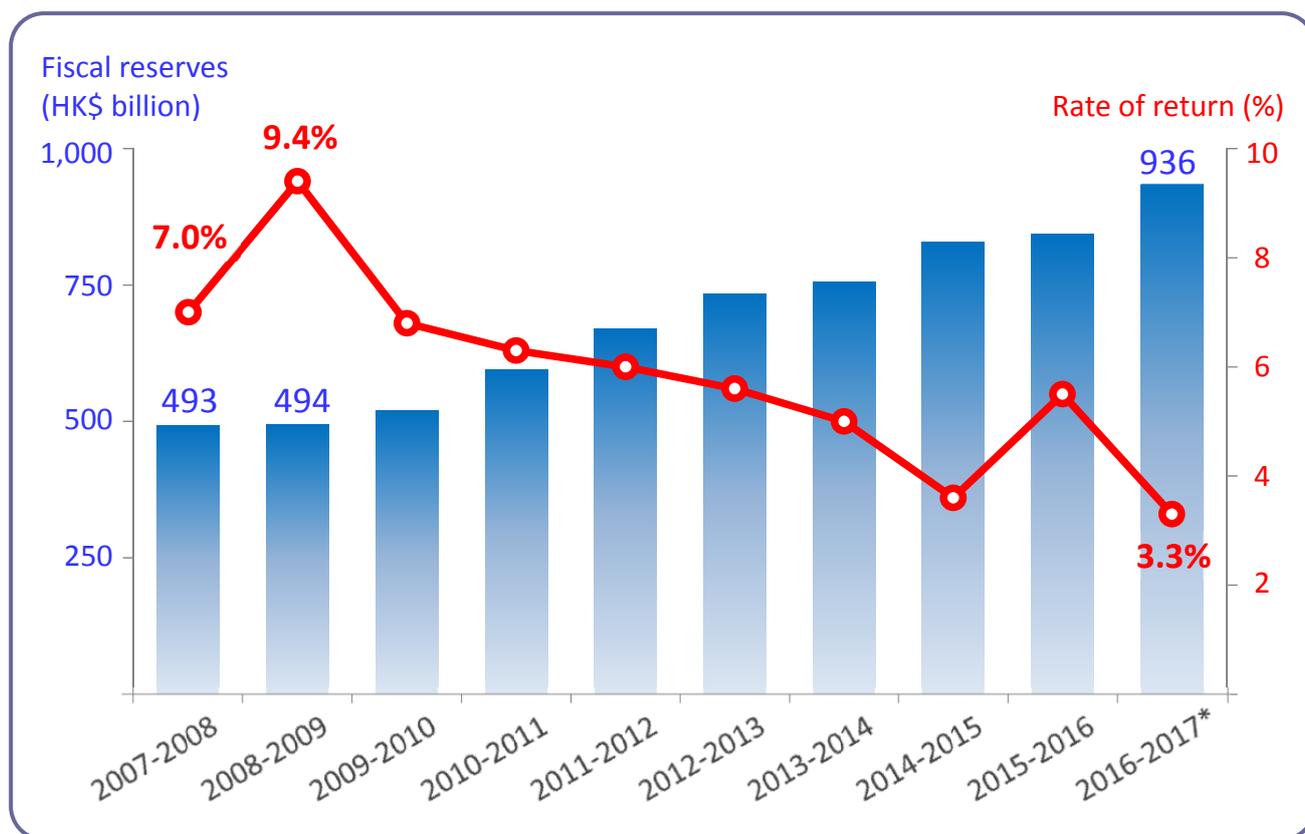
## 5. Fiscal reserves and investment income

5.1 The stock of fiscal reserves is closely related to the outturn of budget balance. After a plunge of 40% in six years during 1997-2003, fiscal reserves staged a strong rebound by a cumulative 240% in the following 13 years to a record high of HK\$936 billion in March 2017 (**Figure 10**). As an invaluable asset of the Hong Kong society, fiscal reserves are placed with the Exchange Fund for investment income.<sup>33</sup> In 2016-2017, annual investment income was HK\$20.7 billion, accounting for 4% of overall government revenue, which is more than enough to meet several policy initiatives announced in the 2017 Policy Address.<sup>34</sup>

<sup>33</sup> Under the fee arrangement for the fiscal reserves placed with the Exchange Fund between the Government and the Hong Kong Monetary Authority, investment income received by the Government is based on the average rate of return of the Investment Portfolio of the Exchange Fund over the past six years. It includes investment income from both operating and capital accounts of the Consolidated Account.

<sup>34</sup> The contribution of investment income to overall government revenue could hit double-digit region at times of economic downswing when other revenue sources were severely dampened by the economic downswing, such as that of 18% in both 1998-1999 and 1999-2000 and 15% in 2008-2009. For 2016-2017, the investment income of HK\$20.7 billion is more than enough to cover the annual recurrent expenditure of new initiatives on free kindergarten education (HK\$2.7 billion), enhancement of the Old Age Living Allowances (HK\$9 billion), forgone annual tax revenue arising from proposed abolition of offsetting payments of severance payments or long service payments with contributions to the Mandatory Provident Fund (HK\$1.8 billion).

**Figure 10 – Size of fiscal reserves and annual rate of investment return, 2007-2008 to 2016-2017\***



Note: (\*) Revised estimate.  
Data sources: Budget speech, various years.

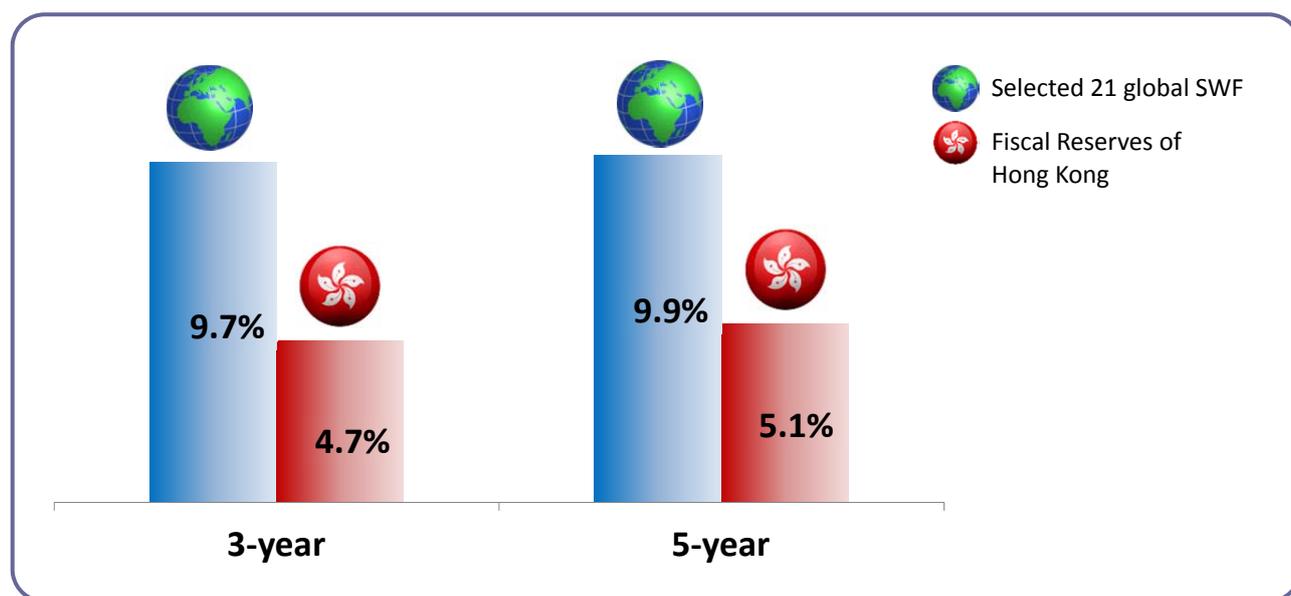
5.2 In view of the significance of investment income to the public coffers, there are concerns over the lackluster investment performance of fiscal reserves in recent years. This is manifested in (a) plummeting overall investment income by 56% from HK\$46.6 billion in 2008-2009 to HK\$20.7 billion in 2016-2017; and (b) the downtrend in the rate of investment return from 9.4% to 3.3% over the past nine years, notwithstanding the robust growth of 89% in the stock of fiscal assets (**Figure 10 above**).

5.3 While this lacklustre return may be in part related to an ultra-low interest rate environment and a more difficult investment climate after global financial crisis in 2008, the rate of investment return in Hong Kong appears to be on the low side when compared with other sovereign wealth funds ("SWF").<sup>35</sup> According to a

<sup>35</sup> In January 2017, the Hong Kong Monetary Authority explained that it had taken three defensive measures over the past three years in the management of Exchange Fund to address the worsening external investment environment. They included (a) reducing the holdings in long-term bonds and increasing short-term bonds and cash to mitigate the negative impact arising from possible increase in US interest rates on bond valuations; (b) reducing the holdings of non-US dollar and non-Hong Kong dollar assets to mitigate the negative currency translation effect caused by a strong US dollar; and (c) expanding investments under the Long-term Growth Portfolio. See Hong Kong Monetary Authority (2017b).

study on investment performance for the reference year of 2015, the median value of the average annual rate of investment return of 21 selected SWF across the globe was 9.7% for a three-year period and 9.9% for a five-year period.<sup>36</sup> They compared with the corresponding rate of return of 4.7% and 5.1% in Hong Kong (Figure 11).<sup>37</sup> There is a concern over the local investment strategy, bearing in mind the anchor principle of prudence.

**Figure 11 – Median value of the average annual rate of investment return of 21 selected global sovereign wealth funds\* at mid-2015**



Note: (\*) See footnote (36) for the composition of these 21 selected SWF.  
Data sources: RVK (2016).

5.4 On the target amount of fiscal reserves, the then Financial Secretary had set a guiding principle in the 2002-2003 Budget that the level of fiscal reserves should be equivalent to "around 12 months of government expenditure". Nonetheless, this guideline has been subsequently revised to maintaining "adequate fiscal reserves in the long run" in the 2007-2008 Budget, without a quantifiable target.<sup>38</sup> For the five years when Hong Kong suffered fiscal deficit during the six-year span from 1998-1999 to 2003-2004, the annual fiscal deficit, which ranged from HK\$7.8 billion to HK\$63.3 billion, was equivalent to about 0.4-3.2 months of

<sup>36</sup> The 21 SWF covered in the study include Abu Dhabi Investment Authority, Australian Future Fund, China Investment Corporation, Norway Global Pension Fund, Government of Singapore Investment Corporation, and a number of SWF in the United States. See RVK (2016).

<sup>37</sup> In the RVK study, mid-2015 is taken as the year of measurement of the median value of the average annual investment return for one year, three years and five years. While the one-year return for the Hong Kong stood at 5.5% in 2015 (as compared to the median return of 3.5% of the 21 selected SWF), it eased back to 3.3% in 2016 and 2.8% in 2017.

<sup>38</sup> See Legislative Council Secretariat (2010).

the then government expenditure.<sup>39</sup> In view of the rising amount of reserves (**Figure 12**), there have been more calls in the community to review this guideline more recently.

**Figure 12 – Fiscal reserves in terms of the number of months of government expenditure, 1997-1998 to 2016-2017\***



Note: (\*) Revised estimate.  
Data sources: Budget speech, various years.

## 6. Observations

6.1 The following observations can be made from the above analysis:

- (a) **Broadly unchanged fiscal landscape:** The structure of public finance in Hong Kong have remained broadly the same over the past two decades, with five major sources (i.e. profits tax, salaries tax, land premium, stamp duties and general rates) accounting for about 71% of overall government revenue in 2016-2017. Despite repeated concerns of the Government over the "narrow tax base" and the

<sup>39</sup> 1999-2000 was the only year recording fiscal surplus during this six-year period.

"particularly volatile revenue" from the property-related items (such as land premium and stamp duties), Hong Kong has been able to achieve fiscal surplus for 13 consecutive years since 2004-2005, without specific measures introduced to diversify revenue sources.

- (b) **Growing relative importance of profits tax:** There has been a visible rise in the revenue contribution of profits tax over the past two decades, while that for salaries tax stayed unchanged. Coupled with a more visible increase in the number of profits tax payers amidst enlarging business profits, this reflects that Hong Kong is still a good place for doing business in the region.
- (c) **Strong fiscal discipline:** Amongst the 35 advanced economies, Hong Kong is the only place sustaining fiscal surplus throughout the past decade, with its stock of fiscal reserves reaching a record high of HK\$936 billion in March 2017. While public expenditure has increased by a cumulative 113% in 20 years, there are public concerns over service gaps in various policy areas. For example, there are long queues for public rental housing, medical services and social welfare services. About half of secondary school leavers meeting entry requirements cannot pursue the undergraduate studies at the publicly-funded universities, due to insufficient subsidized places.
- (d) **Conservative forecasts of revenues and expenditures:** Netting out the deficit years, overall fiscal surplus has accumulated by a total of HK\$561 billion over the past 20 years. Broadly speaking, about 75% of the discrepancy between the forecast and the actual outturn on fiscal balance was attributable to "under-estimation of revenue", and the rest of 25% to "under-spending". It is unclear why there has been continued under-spending over the past 20 years, in particular in the policy areas of education, social welfare and housing. As to the larger-than-expected fiscal surplus, about half of it had been distributed in the form of one-off relief, mostly tax refunds. About 16% of this one-off relief was used as an income redistribution tool to assist grassroots families.
- (e) **Lacklustre investment income from fiscal reserves:** The stock of fiscal reserves surged by 105% over the past 20 years to reach HK\$936 billion in March 2017. Yet investment yield from this enlarging asset base fell from 9.4% to 3.3% over the past nine years, resulting in noticeable reduction in contribution of investment income to overall government revenue over the same period.

- (f) **Review of guideline on fiscal reserves:** In the 2002-2003 Budget, the guideline on target fiscal reserves was set to be "around 12 months of government expenditure", but it was subsequently revised to maintaining "adequate fiscal reserves in the long run" in the 2007-2008 Budget. There have been more calls in the community recently to review this guideline, in view of the continued steep uptrend in fiscal reserves.

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Research Office  
Information Services Division  
Legislative Council Secretariat  
29 March 2017  
Tel: 2871 2125

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