For discussion
on 24 June 2017

# Legislative Council Subcommittee on Retirement Protection

# Progressive abolition of the "offsetting" arrangement under the Mandatory Provident Fund System

## INTRODUCTION

The 2017 Policy Address outlined the Government's proposal to progressively abolish the "offsetting" of severance payment (SP)/long service payment (LSP) with employers' mandatory contributions under the Mandatory Provident Fund (MPF) System. We have since engaged employers and employees in active dialogue and strived to gain their support with a view to finalising the proposal before end-June 2017. However, despite our efforts and the goodwill generated in the past months, both employers and employees are not receptive to the Government's proposal. Nor can they agree among themselves on any alternative that is acceptable to both sides.

2. The abolition of MPF "offsetting" is a matter of considerable public interest as the retirement protection of the over three million employees under MPF or other statutory retirement schemes, who may be subject to SP/LSP dismissals, will be at stake. Removing the "offsetting" arrangement would preserve the retirement protection functions of the MPF pillar to benefit particularly low-income workers. It can also facilitate implementation of "full portability" to further drive down the MPF administrative fees.

3. The consultation period saw a non-compromising stance adopted by employers and employees (the former continuing to oppose to the abolition of "offsetting" while the latter pressing for full preservation of the SP/LSP formula at two-thirds). So far there is no option in sight, not least those put forth by the employers and employees, that can command support from both sides. Notwithstanding the lack of consensus, we consider that it is incumbent upon the current-term Government to exercise leadership and make a decision which we believe is in the overall interests of the community.

4. We recommend that the policy direction of progressively abolishing the “offsetting” arrangement should be reaffirmed and that the Government’s original proposal with the following key features should be adopted as the basis for taking the matter forward —

(a) “offsetting” will be abolished as from an Effective Date with no retrospective effect. In other words, accrued benefits from employers’ mandatory MPF contributions before the Effective Date and the returns derived therefrom will be “grandfathered”. This “grandfathered” amount can be used to offset the SP/LSP payable for the employment period before the Effective Date;

(b) the amount of SP/LSP payable for the employment period from the Effective Date will be adjusted downwards from the existing entitlement of two-thirds of the last month’s wages to half of the last month’s wages as compensation for each year of service (i.e. 75% of existing entitlement); and

(c) the Government will share part of the SP/LSP expenditure of employers in the ten years from the Effective Date. The estimated one-off expenditure is $7.9 billion[1]. The estimated maximum tax forgone arising from tax deductions for making LSP provisions is about $18 billion over ten years[2].

5. We consider the Government’s proposal the most optimal amongst all options raised because of the following considerations —

(a) it is a finely balanced tripartite solution whereby employers, employees and the Government each have to pay extra costs or make some concession, with the consequential impact expected to be largely bearable for all three parties. This “give and take” proposal has balanced the interests of employers and employees while keeping Government’s

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[1] The original estimate in the context of the Policy Address was $6.2 billion over the ten-year period. The $7.9 billion is an updated estimate after taking into account the cyclical slowdown of the economy and aligning the assumptions on moral hazard to ensure like-with-like comparison with other options examined in this paper.

[2] According to the Hong Kong Accounting Standards issued by the Hong Kong Institute of Certified Public Accountants, provisions should be recognised for the LSP liability in financial statement. The provisions made for LSP are tax deductible.

financial involvement one-off and time-limited;

(b) the "grandfathering" arrangement and ten-year government subsidy provide a sufficiently long buffer period for employers to adapt to the policy change. After the abolition of "offsetting", in addition to fully preserving employers' mandatory MPF contributions for retirement, employees will also receive a reasonable compensation in case of SP/LSP dismissals;

(c) it is targeted, requiring only employers with SP/LSP dismissals to pay more while the majority of employers will be unaffected. In overall terms, the additional costs will be generally manageable for most sectors. By continuing to hold employers individually accountable for their own dismissal costs, it incurs little risk of moral hazard and deters irresponsible dismissal behaviour, offering better employment protection for workers; and

(d) it is the most cost-effective option to settle the "offsetting" issue once and for all.

## JUSTIFICATION

### Response from key stakeholders

6. As evident from newspaper editorials and commentaries after the announcement in the 2017 Policy Address, the community is highly supportive of progressively abolishing "offsetting". There is also strong public aspiration that we should tackle the issue head-on and follow through the implementation notwithstanding the change in government in July 2017. Even major employers' groups and political parties with business background have agreed that doing nothing is not an option. They have agreed to pay more to create room for negotiation with trade unions, though some have offered this as a pre-condition for retaining "offsetting".

7. While we are able to make some headway after a series of formal and informal meetings with employers' groups and trade unions, neither groups indicate support to the Government's proposal. Nor can they agree in principle on any alternative that is acceptable to both sides. The following paragraphs provide a more detailed account of their response to the Government's and other proposals.

*Employers' reaction*

8. Employers generally do not favour the Government's proposal. They criticise the Government's proposal as being —

(a) complicated – Government's subsidy rate varied every two years, thus creating additional accounting workload for employers;

(b) Government reneging on its past promise of not requiring employers to "pay twice" – after cessation of the ten-year government subsidy, employers will be left to shoulder the 50% SP/LSP rate in full, which is very close to "pay twice". Cash-tight small- and medium-sized enterprises (SMEs) are believed to be more susceptible to default. Some SMEs may choose to terminate the employment of their staff early to avoid SP/LSP obligations; and

(c) lacking certainty – there is no mechanism to help businesses save up to meet SP/LSP payment for unplanned dismissals.

9. Amongst the counter-proposals from businesses, two proposals seem to have drawn more attention from the business and labour sectors. One proposal seeks to retain "offsetting". In exchange for this, employers will make an additional 1% MPF contribution (the "additional MPF contributions proposal"). It is proposed that the Government should also actively consider making additional 1% contribution to all employees with MPF accounts. Under this proposal, employers are prepared to keep the SP/LSP rate at two-thirds of last month's wages, but propose capping the amount that can be withdrawn by a dismissed employee upon termination of service at say $30,000 or two months' wages, as against the $390,000 cap under the current SP/LSP regime. The crux of the problem, as this proposal has argued, is not "offsetting" but early withdrawal of employers' contribution. So long as the SP/LSP regime is preserved, "offsetting" has to exist side-by-side owing to their overlapping functions with the MPF System, otherwise employers will need to "pay twice". Hence the focus should be shifted from abolition of "offsetting" to safeguarding against early withdrawal of employers' contribution.

10. Another proposal coming from employers is to set up a dedicated fund for paying SP/LSP (the "dedicated fund proposal"). The dedicated fund will be financed by Government's seed money of $15

billion and employers' flat rate levy per employee. The monthly levy may be pitched at two different levels – $100 per employee or $200 per employee. Under the "$100 per employee" scenario, the LSP will be scrapped because of its overlap with MPF, and SP will be paid out of the dedicated fund. Under the "$200 per employee" scenario, both SP and LSP will continue to exist and be met from the dedicated fund. The SP/LSP rate will remain unchanged at two-thirds. This proposal has the support of some SME associations and employers in a number of sectors, with most of them going for the "$100 per employee" scenario with LSP scrapped.

11. There is also a suggestion to replace the MPF System with a publicly-managed Central Provident Fund (CPF). Under the CPF System, employers and Government will make mandatory contributions of 6% and 1.5% for each employee respectively, while contributions from employees are optional. Under this proposal, the SP and LSP will be abolished and replaced by a government-funded redundancy, unemployment and disability fund from which dismissed employees can be compensated under special circumstances.

*Employees' reaction*

12. Unions, while embracing our policy direction of abolishing "offsetting", objected to the Government's proposal on the following grounds —

(a) the SP/LSP entitlement formula would be reduced to half a month's wages per year of service (from the current two-thirds of one month's wages);

(b) using the last month's wages before the Effective Date (instead of the last month's wages before dismissal if the dismissal date comes after the Effective Date) for calculating the SP/LSP benefits for the employment period before the Effective Date, resulting in some employees' receivable entitlements (SP/LSP entitlement together with employers' contribution to their MPF accounts) being less than their current entitlements; and

(c) the "grandfathering" arrangement would not improve the conditions of workers nearing retirement age as their employers' contribution may still be significantly reduced by "offsetting", leaving little or virtually nothing for retirement.

13. Most trade unions find the dedicated fund proposal attractive because under the best case scenario (i.e. the "$200 per employee" scenario) it promises preserving the SP/LSP rate at two-thirds. But there are clear views within the labour sector opposing to meeting the SP/LSP payment in full by the dedicated fund. Specific suggestion has been raised that when a dismissal takes place, the employer concerned should still be required to shoulder half of the SP/LSP, with the other half paid by the dedicated fund (the "risk sharing" model). The "risk sharing" model appears to carry the merit that incident employers (i.e. employers who have initiated dismissals that necessitate SP/LSP payment) should pay more than non-incident employers and hence can more effectively deter irresponsible dismissal behaviour.

14. On the other hand, union representatives have indicated clearly that though appreciative of the employers' willingness to pay more, they would not accept the additional MPF contributions proposal. Not only would it perpetuate the "offsetting" arrangement, the proposed additional 2% MPF contributions from employers and the Government would not be sufficient to cover fully the SP/LSP even under the Government's proposal of one-half of last month's wages and, least of all, if the SP/LSP rate were to be kept at two-thirds as purported by the employers' groups. They also do not find the additional gain of 2% MPF contributions for non-incident employees attractive.

**Policy and financial analyses of options**

*The additional MPF contributions proposal*

15. The additional MPF contributions proposal has its merits in that it is easy to understand and simple to administer. The additional contributions will be made to the MPF System which both employers and employees are familiar with. There is no need to create a new mechanism to disburse government subsidy or manage a fund as in the Government's proposal and the dedicated fund. All the 2.6 million employees with MPF accounts will have their retirement benefits boosted — their non-employees' contribution will be increased by 40% if the additional 2% contributions from employers and Government were to be taken into account. In monetary terms, the annual contribution of 1% to the 2.6 million employees, amounting to $5.4 billion in total, will more than cover the "offsetting" amount of about $3 billion per year.

16. The proposed additional employers' contribution is welcomed. Employers' commitment to pay more shows their sincerity in reaching a

deal with unionists. Yet, "offsetting" remains unresolved. For the some 49 000 incident employees according to 2016 data (i.e. the vulnerable group we set out to protect in the exercise), they could gain very little or even nothing financially. The vast majority of their employers' contribution will continue to be used for offsetting their SP/LSP payment, though employers would argue that the leakage from the MPF System will be mitigated by the proposed cap on the withdrawable amount. Continued existence of "offsetting" will also hamper the long-term development of the MPF System. It will remain a reason for employers to argue against the implementation of "full portability".

17. We consider the proposed long-term involvement of Government in the MPF pillar very problematic. First, Government's intervention in retirement protection has all along been justified on the "needs" approach. Under our multi-pillar system, Government supports the needy elderly through means-tested social security programmes such as the Comprehensive Social Security Assistance and Old Age Living Allowance (OALA), while the employment-based MPF is designed to be a co-contributory system by employers and employees. Extending Government's involvement to the MPF pillar will blur our role under the regime, especially if this is done regardless of the needs of the 2.6 million employees with MPF accounts. Secondly, the resource requirement will be substantial. As mentioned above, the 1% contributions to all the 2.6 million employees under the MPF System would cost about $5.4 billion per year. If this becomes a lasting rather than time-limited measure, the burden on public finance would be long-term. And this will be on top of what the Government has already committed to spending in other retirement protection pillars. For example, with the passage of the 2017 Appropriation Bill, the improvement measures to the OALA for needy elderly will entail additional annual expenditure of about $11 billion up to 2064-65 on average. Thirdly, making contributions indiscriminately for all the 2.6 million employees under the MPF System is not prudent use of public resources.

*The dedicated fund proposal*

18. The dedicated fund is essentially an insurance-type arrangement because it creates a "risk pool" to be financed by all employers from which the dismissal cost of an individual employer is to be borne, in full or in part. The existing Protection of Wages on Insolvency Fund (PWIF) operates on a similar concept, except that in accordance with the relevant legislation bankruptcy/winding up petition has to be presented

against the employer[3], whereas the dedicated fund requires no such legal procedure. In ascertaining the financial viability of the dedicated fund, we have, for comparison purpose, adapted a model based on the key features of the dedicated fund proposal and the "risk sharing" model, and major parameters of the Government's proposal where appropriate. The adapted model has the following features –

(a) SP/LSP rate at 50% to be consistent with that for the Government's proposal;

(b) the dedicated fund to be financed by —

  (i) as start-up, Government's upfront injection of $6.2 billion being the original estimate of the ten-year subsidy under the Government's proposal; and

  (ii) as on-going income source, a flat-rate annual levy payable by employers for each of his employees;

(c) employers' share of SP/LSP rate at 25% points (i.e. half of the SP/LSP liability) or 30% points (i.e. 60% of the SP/LSP liability), with the rest by the dedicated fund, to reduce moral hazard risk and possible abuse. In addition to these two preferred scenarios, we have, for comparison purpose, included in our assessment the scenario of having the SP/LSP paid in full by the dedicated fund;

(d) higher SP/LSP incidence to take into account possible moral hazard risk and abuse having regard to employers' share of the SP/LSP liability in (c) above; and

(e) the dedicated fund to be financially sustainable for 30 years.

19. Based on the above features, we have summarised in the following table the estimated break-even level of annual levy per

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[3] Employees whose employers have become insolvent and failed to pay their wages and termination payments may apply to PWIF for ex gratia payment in accordance with the Protection of Wages on Insolvency Ordinance (Cap. 380). PWIF is mainly financed by an annual levy of $250 on each Business Registration Certificate. In accordance with the relevant legislation bankruptcy/winding up petition has to be presented against the employer, usually with the assistance of the Legal Aid Department. The different items of ex gratia payment provided by PWIF are capped. For example, $36,000 for arrears of wages, $50,000 plus 50% of any excess entitlement for severance payment.

employee that can keep the dedicated fund financially sustainable for 30 years under the "0%", "25%" and "30%" scenarios[4] —

| Scenarios | Share of 50% SP/LSP rate between employers : dedicated fund | % of SP/LSP cases higher than "Base Case"(1) due to moral hazard risk and possible abuse | Annual levy(2) per employee(3) in 2016 prices under "Economic Shock" Scenario(4) |
|---|---|---|---|
| "0%" | 0 : 50% pts | 50 - 100% | $3,000 - $3,900 |
| "25%" | 25 : 25% pts | 25 - 60% | $1,300 - $1,600 |
| "30%" | 30 : 20% pts | 20 - 40% | $1,000 - $1,100 |

(1) The "Base Case" Scenario corresponds to the estimated number of SP/LSP cases under the Government's proposal. The estimates were made based on the MPF Authority's administrative records for SP/LSP offsetting cases in 2015, with suitable adjustments to take into account (i) those cases which are not subject to MPF offset; (ii) the projected demographic profile of our labour force; and (iii) economic fluctuations.

(2) Rounded figures.

(3) The number of employees over the assessment period is assumed to broadly follow the latest projected trend of local labour force, as published by Census and Statistics Department in September 2015.

(4) The"Economic Shock" Scenario assumes that the economy would experience cyclical slowdown for two years out of every ten-year period, under which the number of SP/LSP cases would double when compared to the "Base Case".

20. The above table shows that if the SP/LSP is to be fully borne by the dedicated fund, the estimated annual levy of $3,000-$3,900 per employee would exceed the $1,200 or $2,400 as originally estimated by the employer proponent, which has not taken into account the possible increase in SP/LSP cases owing to moral hazard risk and possible abuse. If an employer is not required to shoulder any direct dismissal cost, he will possibly lay off employees more readily. There may also be a higher chance of collusion between employers and employees. These morally hazardous behaviours will increase the number of SP/LSP claims and thus the amount of employers' levy contribution.

21. Moral hazard may, however, be mitigated by requiring employers to bear a sufficiently large share of the dismissal costs. The higher the employer's share of the SP/LSP liability, the lower the likelihood of moral hazard/abuse cases, and thus the less expensive will be the proposal. We have accordingly assumed a smaller increase in SP/LSP cases owing to moral hazard risk and possible abuse for the "25%" and "30%" scenarios where employers will be responsible for 50% and 60% of the SP/LSP payment respectively. The estimated break-even level of the annual levy per employee will be reduced to

[4] Implicit in the estimations are the assumptions that (i) investment return of the dedicated fund balance would earn a real rate of 1% per annum; and (ii) employees' wages would rise at 1% in real terms per annum, broadly similar to the historical trend over the past 30 years.

$1,300-$1,600 for “25%” scenario and $1,000-$1,100 for “30%” scenario. From the efficiency angle, it is thus more preferable to design the dedicated fund in such a way that incident employers bear a significant portion of the SP/LSP liability when it is triggered.

22. The dedicated fund can go some way toward addressing employers’ concern about “uncertainty” and “paying twice” as the resources required of employers will be more predictable and manageable. All employers, incident or otherwise, will be required to make the levy contribution at a pre-set flat rate for each employee. Additionally, for incident employers, they will have to bear 50% or 60% of the SP/LSP payment. Yet the total costs to incident employers will still be lower than what would otherwise be under the Government’s proposal as the SP/LSP will be co-shared by incident employers and the dedicated fund.

23. Employers are divided about the dedicated fund proposal. While some employers support the “$100 per employee” scenario with the LSP scrapped, major employers’ groups have expressed two concerns. First, equity consideration. By requiring all employers to contribute, the proposal will involve cross-subsidisation from firms or industries with lower SP/LSP incidence to those with higher incidence, and from firms with lower staff turnover rate to those with higher staff turnover rate. Hence the dedicated fund would increase the cost burden of the vast majority of employers who rarely need to pay SP/LSP (according to data of past three years, only about 5-6% employers enrolled under the MPF System were involved in “offsetting” each year). The proposal would also be less equitable to most employees who seldom receive SP/LSP upon termination of service, but their employers may seek to absorb the levy contribution through lower pay increase (according to data of past three years, only about 2% of employees enrolled under the MPF System were subject to “offsetting” each year). Many employers consider that fund set aside by employers for paying SP/LSP should be used for paying their own employees, rather than to a central pool to benefit employees of other employers.

24. Secondly, employers are gravely concerned about possible abuse. While requiring employers to shoulder part of the SP/LSP payment can reduce moral hazard, it cannot eliminate abuse. The employers’ groups are particularly concerned about abuse from industries where most employees are employed on fixed-term contracts and hence may be tempted to draw benefits from the fund each time when their contracts expire.

25. Operationally, the dedicated fund will be more complex. There needs to be legislative back-up and establishment of a permanent office to collect levy contributions, process and verify SP/LSP claims, take enforcement measures to guard against abuse, etc. The administrative and policing costs would be substantial. The Government may also have to bail out the dedicated fund if it runs into financial difficulty and that levy would unlikely be raised to fill the gap, particularly in times of economic downturn.

*Cost comparison across options*

26. The costs of the three options, viz. additional MPF contributions, the dedicated fund and the Government's proposal, can be assessed from four angles – unit additional cost to individual employers; total additional cost to all employers; total additional cost to Government; and total cost to society as a whole. To facilitate comparison across three options, we have summarised the cost information based on the above four parameters and 30-year timeframe in the table at **Annex**.

27. Based on the "unit additional cost to individual employers", the Government's proposal will cost the most to incident employers as they will bear the 50% SP/LSP rate in full after the government subsidy ends, and the least to non-incident employers as there is no additional cost (it should be noted that non-incident employers account for the majority of employers as illustrated in the table under paragraph 33(c)). The dedicated fund will cost less to incident employers as all or part of the SP/LSP liability will be passed on to non-incident employers. The proposal of additional MPF contributions carries the same cost implications for both incident and non-incident employers in terms of percentage of employees' wage bills.

28. In terms of "total additional cost to all employers", the Government's proposal and the additional MPF contributions proposal are less expensive than the dedicated fund. In terms of "total additional cost to Government", the additional MPF contributions proposal is the most expensive followed by the Government's proposal. The dedicated fund should be the least costly to the Government if they only involve Government's seed money of the proposed amount and granting no government bailout/underwriting if the scheme turns out to be financially unsustainable.

29. In terms of "total cost to society as a whole", i.e. all employers and the Government altogether, the additional MPF contributions proposal is the most costly as it requires contributions from all

employers and the Government for both incident and non-incident employees. Amongst the dedicated fund options, the "25%" and "30%" scenarios should be more cost-effective as there will likely be less moral hazard risk and possible abuse cases when the incident employers have to shoulder a larger share of the dismissal costs. The Government's proposal should be the most cost-effective one with the lowest risk of moral hazard and possible abuses cases, granting that the government subsidy will be progressively reduced to zero.

*Key considerations for our recommendation*

30. In view of the strong public demand for the Government to tackle "offsetting" head-on, we recommend that the policy direction of progressively abolishing "offsetting" should be upheld. On the question of how, so far we see that the additional MPF contributions proposal will not be a promising solution – not only will the "offsetting" dispute persist, the proposal will also carry far-reaching implication in terms of Government's role and financial commitment under the existing retirement protection system.

31. The dedicated fund is not without merits. It can provide greater cost certainty for employers. But it will be more costly to society as a whole than the Government's proposal because of the induced SP/LSP cases owing to the moral hazard risk and possible abuse. Requiring incident employers to shoulder part of the SP/LSP cost, say 50% of the SP/LSP payment, can alleviate the problem and bring the annual levy level down to about $1,300 per employee. Yet all employers are required to pay, while only a small portion of them need to use the fund every year. Some employers have questioned the desirability of such a design whereby incident employers are required to pay most of the total SP/LSP payment on top of their levy contributions to the dedicated fund. Such high level of top-up rates may run counter to the very objective of setting up the dedicated fund, which is to provide some form of "insurance coverage" or "certainty" to employers and reduce the out-of-pocket payment by incident employers.

32. In the last few weeks, there has been discussion on another alternative option - to abolish the "offsetting" of SP first and keep the SP formula at two-thirds, with LSP continuing to be subject to "offsetting" until the issue would be resolved at a later date (the split approach). Employers have generally suggested that more time is needed for studying the impact of the split approach on businesses and do not want to rush through any decision without properly and fully consulting their member organisations. Many unionists have rejected an open-ended

review for LSP "offsetting". Instead, they have pressed for a clear commitment by the Government and the business sector to the effect that two or three years after the abolition of SP "offsetting", the LSP "offsetting" should also be abolished while preserving the LSP formula at two-thirds. This is tantamount to a phased implementation of the abolition of SP/LSP "offsetting" with the calculation formula maintained at two-thirds. From the employers' perspective, this would be a less palatable proposition as compared to the Government's proposal in which the SP/LSP formula would be suitably adjusted to one-half to reflect the partial overlap between SP/LSP and MPF. Doubts have been cast whether this split approach would be more beneficial to employees when compared with the Government's proposal, as businesses generally see that LSP and MPF have highly similar functions and that the former should be redefined with a much narrower scope or even scrapped. There is also the concern that if only SP is not subject to the "offsetting" arrangement, dismissed employees might attempt to claim SP in all dismissal cases with employers arguing the other way round, and it would likely lead to more disputes between employers and employees. Given the divergent views of employers and employees and the limited time available to resolve the controversial issues involved (such as preserving the SP formula at two-thirds and the uncertainty surrounding the proposed review of LSP "offsetting"), it would not be practically possible for a definitive view to be reached on the split approach.

33. Having examined carefully views received from employers and employees, we consider that on balance, the Government's proposal remains the most optimal amongst all proposals raised for the following considerations —

(a) the Government's proposal will attain the progressive abolition of "offsetting", the policy objective we set out to achieve in this exercise. It is a finely balanced tripartite solution whereby employers, employees and the Government each have to pay extra costs or make some concession, with the consequential impact expected to be largely bearable for all three parties. It is a "give and take" proposal that has balanced the interests of employers and employees while keeping Government's financial involvement one-off and time-limited;

(b) the "grandfathering" arrangement and ten-year government subsidy provide a sufficiently long buffer period for employers to adapt to the policy change. After abolition of "offsetting", in addition to fully preserving employers'

mandatory MPF contributions for retirement, employees will also receive a reasonable compensation in case of SP/LSP dismissals;

(c) as summarised in the following table, the proportion of employers and employees involved in MPF "offsetting" is small — about 5-6% and 2% of employers and employees enrolled under the MPF System respectively were subject to "offsetting" annually in the past three years —

| Year | MPF benefits withdrawn for "offsetting" | Number of employers involved | Average "offsetting" amount per employer | Number of employees involved | Average "offsetting" amount per employee |
|---|---|---|---|---|---|
| 2014 | $3.006 billion | 15 600 (5.7%) | $192,800 | 43 500 (1.7%) | $69,200 |
| 2015 | $3.354 billion | 14 400 (5.2%) | $233,000 | 45 300 (1.8%) | $74,100 |
| 2016 | $3.855 billion | 14 900 (5.4%) | $258,200 | 49 300 (1.9%) | $78,300 |

(1) In the three years, about 88.5-89.7% of the total "offsetting" amount came from employers' mandatory contribution, with the remaining from voluntary contribution.
(2) Figures in ( ) denote the percentage of enrolled employers and employees subject to the "offsetting" arrangement.

Consistent with the scale of the "offsetting" problem and the user-pay principle, the Government's proposal requires only incident employers to pay more, while the majority of employers will be unaffected. On the other hand, the other two options of additional MPF contributions and dedicated fund will incur additional costs for all employers in Hong Kong, regardless of whether they have initiated SP/LSP dismissals; and

(d) the Government's proposal is the most cost-effective to society as a whole mainly because, by holding employers individually accountable for their own dismissal costs, they will be more discreet in their dismissal actions. The moral hazard risk and possible abuse cases will be significantly reduced and little or no resources will be wasted as a result.

34. The Government's response to employers' concerns in paragraph 8 above is set out below —

| Employers' concern | Government's response |
| --- | --- |
| (a) complicated – Government's subsidy rate varied every two years creating additional accounting workload for employers | We will mount a large-scale promotion campaign to assist employers and employees in the calculation of SP/LSP payment and government subsidy. Specific measures include –<br><br>(i) producing pamphlets with specific examples and developing on-line, user-friendly tool to help employers calculate the government subsidy;<br><br>(ii) providing in-person consultation service in the ten district offices of the Labour Relations Division under the Labour Department (LD); and<br><br>(iii) putting in place simple, easy-to-understand reimbursement procedures for government subsidy. |
| (b) Government reneging on its past promise of not requiring to "pay twice" – after cessation of the ten-year government subsidy, employers will be left to shoulder the SP/LSP rate of 50% in full, which is very close to "pay twice". Cash-tight SMEs are believed to be more susceptible to default. Some SMEs may choose to terminate the employment of their staff early to avoid SP/LSP obligations | While agreeing to extend the "offsetting" arrangement to the MPF System to avoid employers "paying twice" during LegCo's scrutiny of the MPF Schemes Bill in 1995, the Government also acknowledged the need to rationalise the relationship between SP/LSP and MPF.<br><br>Under the Government's proposal, employers are not "paying twice" because –<br><br>(i) the SP/LSP entitlement will be adjusted downward from existing two-thirds (66.7%) to one-half (50%); and<br><br>(ii) employers' MPF contributions are normally not enough to meet the SP/LSP payment in full. At present, on average employers are still required to meet 17% of the total SP/LSP (or 11% of monthly wages) by their own funds after "offsetting". Hence the net additional cost to employers would be even lower at 39% (50%-11%).<br><br>In addition, according to the Business Impact Assessment conducted by the Government Economist, given the "grandfathering" arrangement and government subsidy over the transitional period, in overall terms, despite an increase in expenses to be borne by incident |

| Employers' concern | Government's response |
|---|---|
| | employers, the additional cost entailed from the proposal should be largely manageable for most sectors.<br>As shown by the 2015 data, more than half of the incident employers only had one employee subject to "offsetting" and the "offsetting" amount per employee was about $90,000. |
| (c) lacking certainty – there is no mechanism to help businesses save up to meet SP/LSP payment for unplanned dismissals | With the "grandfathering" arrangement and ten-year government subsidy, employers will have sufficiently long time to absorb or mitigate the rise in costs, and put on necessary reserve. |

35. As for employees' concerns in paragraph 12 above, we propose making technical adjustment to the implementation details of the abolition arrangement to ensure that dismissed employees will not be worse off financially under the Government's proposal than they are now. The "grandfathering" arrangement is necessary to reduce the risk of large-scale dismissals in the run-up to the Effective Date. Should there be no "grandfathering" arrangement, for dismissals taking place after the Effective Date, employers will need to meet the full SP/LSP payment by his own funds for the entire employment period including the years of service before the Effective Date. There would be a strong likelihood that employers are induced to dismiss employees particularly long-serving employees and exercise their statutory right of "offsetting" before abolition takes effect in order to cut down subsequent SP/LSP liability.

36. The revision of the SP/LSP rate to one-half is justifiable in view of the partial overlap between the functions of SP/LSP and the MPF System. It is not correct to see this adjustment as a retrograde step in employment benefits because the SP/LSP receivable will be additional to employers' mandatory MPF contributions which will be fully preserved for retirement. The overall monetary amount most employees can get under the Government's proposal will be notably higher than the existing arrangement. It should also be noted that while trade unions have been pressing for full preservation of the two-thirds formula, some employers have proposed scrapping the LSP. Reinstating the formula to two-thirds means that employers would be required to "pay twice" exactly upon cessation of the ten-year subsidy.

**Other related issues**

37. Apart from employers' MPF contributions, the Employment Ordinance (Cap.57) also allows offsetting of SP/LSP with employers' contribution under the occupational retirement schemes governed by the Occupational Retirement Schemes Ordinance (ORSO) (Cap. 426) and other occupational retirement schemes provided for in an employee's employment contract, such as the school provident fund schemes under the Grant/Subsidized Schools Provident Fund Rules under the Education Ordinance (Cap. 279), as well as gratuities based on length of service. The abolition arrangements with suitable adaptations will be extended to the ORSO schemes and two school provident funds with the same Effective Date set for the MPF System, while gratuities as voluntary payment made by employers can continue to be used to offset SP/LSP.

38. In addition to the above, the following measures will continue to be upheld –

(a) employees not covered by the MPF System – currently domestic helpers, whether foreign or local, and workers aged below 18 or aged 65 or above, are not covered by the MPF System. For employees who are not covered by MPF or other statutory retirement schemes, given that they are not to benefit from the abolition of "offsetting", their SP/LSP entitlements at the current quantum will remain unchanged. Their employers will also not be entitled to be reimbursed with any subsidy from the Government even if any SP/LSP cost is incurred; and

(b) voluntary contributions under the MPF System – the abolition of "offsetting" will not be applicable to voluntary contributions under the MPF System (i.e. those in excess of the mandatory 5%). Likewise, employers' contribution in excess of 5% under ORSO schemes and school provident funds can continue to be used for "offsetting".

## IMPLICATIONS OF THE GOVERNMENT'S PROPOSAL

### Financial implications

39. The Government's one-off financial commitment and tax forgone of the proposal are recapitulated below –

| | | Estimated expenditure or tax forgone for next ten years ($ billion in 2016 prices) |
|---|---|---|
| Government's one-off commitment | "Base Case" Scenario(1) | 6.3(3) |
| | "Economic Shock" Scenario(2) | 7.9 |
| Maximum tax forgone related to making LSP provisions | | 18.0 |

(1) The "Base Case" Scenario implicitly assumes near full employment albeit with some economic fluctuations during the period.
(2) The "Economic Shock" Scenario assumes that the economy would experience cyclical slowdown for two years out of every ten-year period, under which the number of SP/LSP cases would double when compared to the "Base Case".
(3) The original estimate in the context of the 2017 Policy Address was $6.2 billion over the ten-year period, assuming the arrangement will be in place in 2017. This estimate has been slightly revised to the $6.3 billion after aligning the assumptions on moral hazard to ensure like-with-like comparison with other options examined in this paper.

### Economic implications

40. The abolition of the "offsetting" arrangement would entail additional cost on employers. Sectors with higher incidence of triggering SP/LSP and those SMEs with thinner profits would face somewhat larger cost burden than others. With due regard to the affordability of employers, the proposed "grandfathering" arrangement and the time-limited subsidy over a period of ten years will help alleviate the impact of the policy change on enterprises, thereby mitigating the risk of massive layoffs and the consequential potential shocks to the labour market. With these transitional arrangements in place, it can be envisaged that the additional financial burden on the affected enterprises would be notably smaller in the first few years after the policy change.

41. In gist, the "grandfathering" arrangement purports to allow time for employers to adapt to the policy change and take mitigation measures during the transitional period. All in all, enterprises, having taken into account the specific circumstances of their industry and their cost

structure, would adopt different strategies to absorb or mitigate the rise in costs over time. Together with the ten-year government subsidy, the cost impact on employers should be generally manageable for most sectors.

## ADVICE SOUGHT

42. Members are requested to comment on the content of this paper.

**Policy and Project Co-ordination Unit**
**Chief Secretary for Administration's Office**
**23 June 2017**

# Cost of different options to employers, Government and society as a whole

(All cost estimates are based on the lower bound moral hazard assumptions in 2016 prices)

**Annex**

This table shows how different options will cost to employers (unit additional cost and total additional cost for all employers), the Government and society as a whole in the first 30 years.

**(A) For illustrating the unit additional cost**, we have assumed that the employee's monthly wage remains unchanged at $15,000 throughout the six-year employment period.
SP/LSP payable for six years under reduced SP/LSP rate of 50% = $15,000 x 0.5 x 6 = $45,000
If SP/LSP retained at existing 66.7% = $15,000 x 2/3 x 6 = $60,000

| | (a) Government's proposal with ten-year subsidy | | (b1) Dedicated fund (alternative 1) 0% pt by employers 50% pts by dedicated fund | | (b2) Dedicated fund (alternative 2) 25% pts by employers 25% pts by dedicated fund | | (b3) Dedicated fund (alternative 3) 30% pts by employers 20% pts by dedicated fund | | (c) Additional MPF contributions with offsetting allowed and capped withdrawable amount[1] | |
|---|---|---|---|---|---|---|---|---|---|---|
| SP/LSP rate per year of service (% of last month's wages) | 50% | | 50% | | 50% | | 50% | | 66.7% | |
| MPF offsetting? | abolished from Effective Date | | abolished from Effective Date | | abolished from Effective Date | | abolished from Effective Date | | SP/LSP offset against 5+1% employers' contributions | |
| | Incident employer | Non-incident employer | Incident employer | Non-incident employer | Incident employer | Non-incident employer | Incident employer | Non-incident employer | Incident employer | Non-incident employer |
| SP/LSP to be met by - | | | | | | | | | | |
| **MPF contribution** | | | | | | | | | | |
| *original mandatory 5%* | preserved ($54,000) | preserved ($54,000) | preserved ($54,000) | preserved ($54,000) | preserved ($54,000) | preserved ($54,000) | preserved ($54,000) | preserved ($54,000) | $15,000 x 5% x 72 months = $54,000 (offset: $54,000; preserved : $0)[6] | preserved[6] ($54,000) |
| *additional contributions* | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | $15,000 x 1% x 72 months = $10,800 (offset: $6,000; preserved: $4,800)[6] | preserved[6] ($10,800) |
| **new levy** | ---- | ---- | $3,000[2] x 6 years = $18,000 | $3,000[2] x 6 years = $18,000 | $1,300[2] x 6 years = $7,800 | $1,300[2] x 6 years = $7,800 | $1,000[2] x 6 years = $6,000 | $1,000[2] x 6 years = $6,000 | ---- | ---- |
| **out-of-pocket expenses** | $45,000 (from Yr 11) | ---- | ---- | ---- | $22,500 (all years) | ---- | $27,000 (all years) | ---- | ---- | ---- |
| Unit additional cost to employer (expressed as % of total wages throughout the six-year employment period)[3] | $45,000 (4.2%) (from Yr 11) | ---- | $18,000 (1.7%) | $18,000 (1.7%) | $30,300 (2.8%) | $7,800 (0.7%) | $33,000 (3.1%) | $6,000 (0.6%) | $10,800 (1%) | $10,800 (1%) |

**(B) Estimated total additional costs under the "Economic Shock" Scenario for options (a) - (c), with built-in moral hazard / abuse cases[5]**

| | (a) | (b1) | (b2) | (b3) | (c) |
|---|---|---|---|---|---|
| (i) Total additional cost to all employers (incident and non-incident) in the first 30 years[3] | $183.0 billion | $258.8 billion | $228.3 billion | $220.7 billion | $162 billion |
| (ii) Total additional cost to Government in the first 30 years | $7.9 billion | $6.2 billion | $6.2 billion | $6.2 billion | $162 billion |
| (iii) Total cost to society in the first 30 years (= (i) + (ii))[4] | $190.9 billion | $265.0 billion | $234.5 billion | $226.9 billion | $324 billion |
| Estimated max. tax forgone in first 15 years | $30.8 billion | $15.7 billion | $26.1 billion | $28.3 billion | $10.3 billion |

1. The five employers' groups have proposed that the additional 1% employer contribution is conditional upon additional 1% contributions from Government. The crude cost estimate is solely based on MPFA data for 2016 without any adjustment to number of employees and wage levels for subsequent years.
2. Initial assessment shows that, with Government's seed money of $6.2 billion, the crudely estimated break-even levels of annual levy per employee (rounded up to the nearest hundred) for maintaining the financial sustainability of the proposed dedicated fund for 30 years should be at least in the order of some $3,000-$3,900, $1,300-$1,600, and $1,000-$1,100 (2016 prices) in (b1), (b2) and (b3) respectively under the "Economic Shock" Scenario.
3. "Additional cost" includes additional MPF contributions/new levy/out-of-pocket expenses.
4. The figures refer to the estimated financial outlay only. There are other cost implications for Government in terms of revenue forgone for LSP provisions/levy contribution/additional MPF contribution as deductible expenses.
5. Under the "Economic Shock" Scenario, the number of SP/LSP cases is assumed to double for the 4th and 5th years in every ten-year period to cater for higher payouts during occasional economic slowdown. For the sake of comparison, the lower bound moral hazard assumptions are deployed in the above estimations.
6. The five employers' groups have proposed that the offset amount that can be withdrawn should be capped at $30,000 or two months' wages. For illustration purpose, we have assumed that the employee has completed his six-year employment at the end of Yr 6. In other words, throughout his six years of service, his employer's contribution rate is 6%.