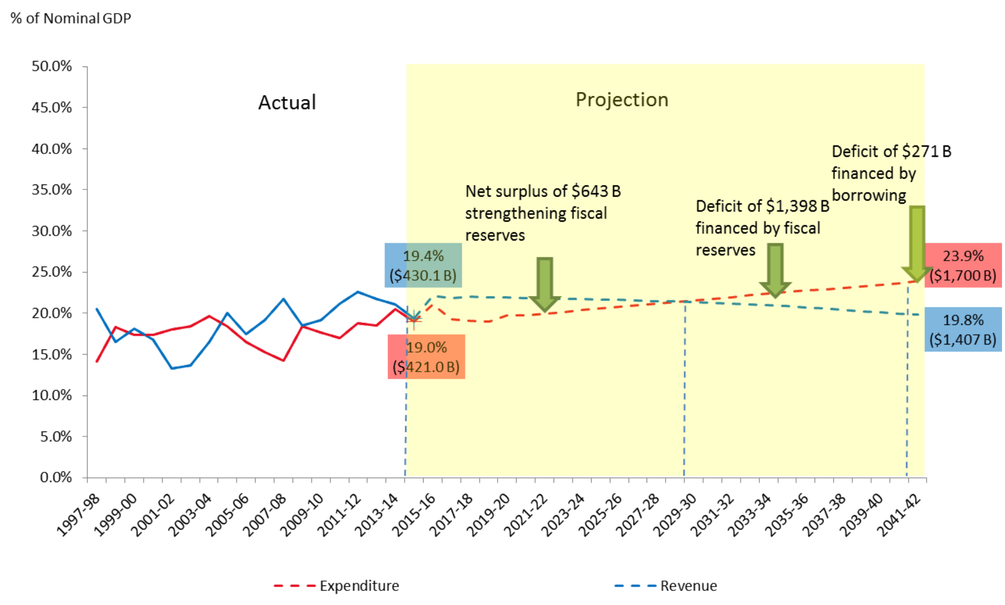
Chapter 5 – Fiscal Sustainability

Overview

5.1 This Chapter consolidates the expenditure and revenue projections set out in Chapters 3 and 4, and presents the overall fiscal outlook of the Government up to 2041-42.

5.2 The projection results indicate that under the **No Service Enhancement Scenario**, where only demographic changes and price factors are assumed, there would a persistent shortfall in revenue to finance the Government's operations, i.e. a structural deficit, as from the year 2029-30 under the Base Case.

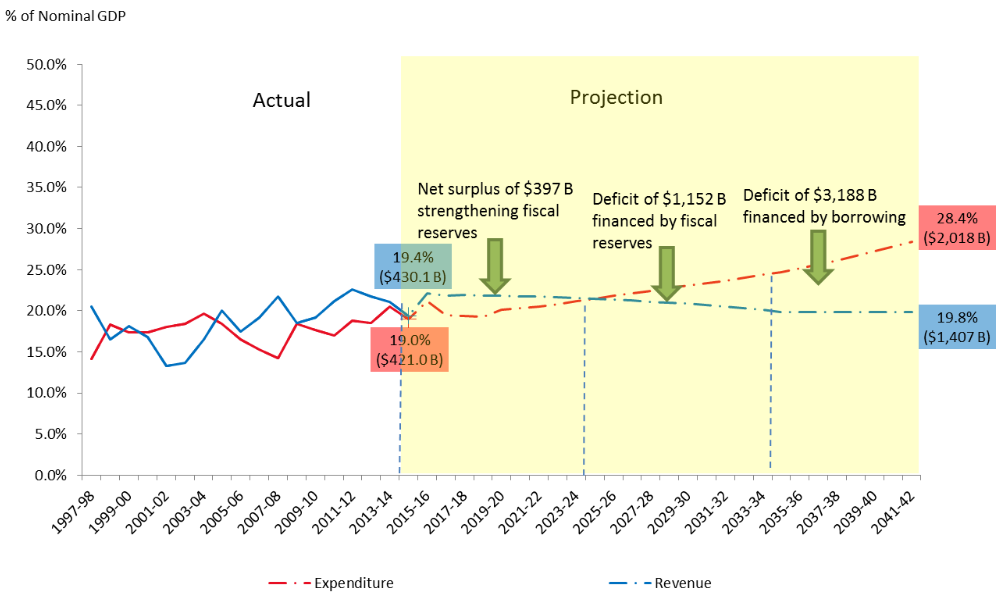
Chart 5.1 – Projection on revenue and expenditure under Base Case, No Service Enhancement Scenario



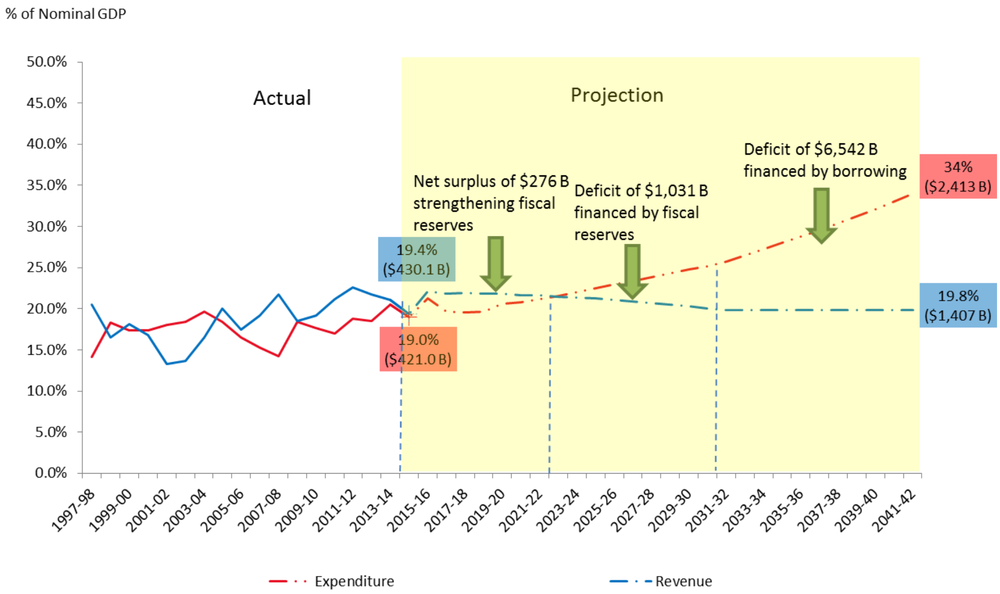
5.3 **Under the various Service Enhancement Scenarios**, where services for education, social welfare and health would be enhanced at either 1%, 2% or rates trailing the historical trends of the respective spending programmes, and where capital works and other expenditure items would remain a constant share of GDP, a structural deficit would surface even earlier, between 2021-22 and 2024-25, under the Base Case.

Chart 5.2 – Projection on revenue and expenditure under Base Case, Service Enhancement Scenarios

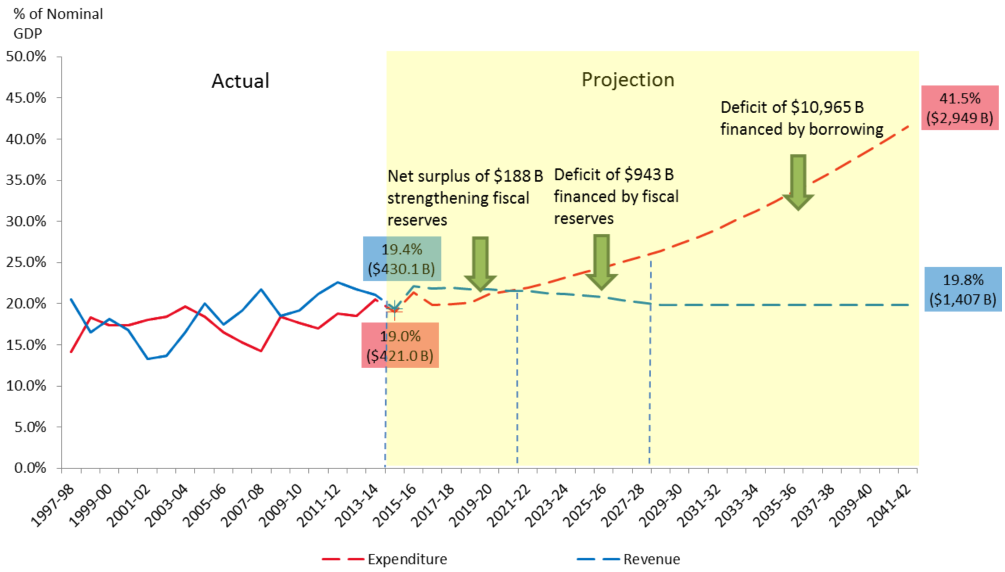
@1% per annum



@2% per annum



@ Historical Trend



5.4 It is worth noting that structural deficit differs from a cyclical deficit in that it exists regardless of the point in the business cycle (i.e. not resulted from changes in the economic cycle). Structural deficit is caused by an underlying imbalance in government revenue and expenditure.

5.5 Once a structural deficit strikes, the Government would need to dip into the fiscal reserves to finance the Government's operations. The draw down of the fiscal reserves balance would reduce the investment income and hence further worsen the deficit problem.

5.6 Unless something could be done in the circumstances to redress the structural deficit problem, the fiscal reserves would be depleted within a decade or so (within 12 years under the No Service Enhancement Scenario, or within seven to ten years under the Service Enhancement Scenarios) after the onset of the structural deficit.

5.7 Sensitivity analyses under different macroeconomic assumptions (i.e. the High Case, Low Case and Shock Case defined in Chapter 2) show similar results with structural deficit anticipated to surface within a decade or two.

5.8 The projections have not taken into account the potential financial support needed for the Housing Authority. If the projected $490 billion funding shortfall of the Housing Authority has to be met by government injections, the surface of structural deficit and depletion of the fiscal reserves would be both advanced by three years under the No Service Enhancement Scenario.

Fiscal outlook

5.9 Under the **Base Case** macroeconomic assumptions, the structural deficit problem would start in 2029-30 even in the **No Service Enhancement Scenario** (*Chart 5.1*). The structural deficit would continue to grow thereafter.

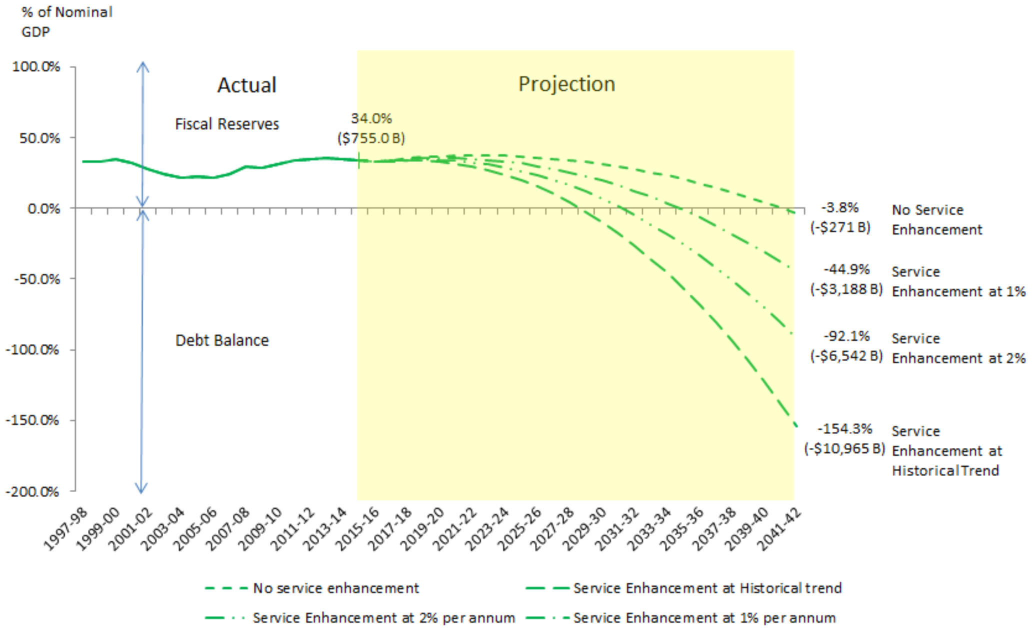
Base Case	Projected start of Structural Deficit	Projected depletion of Fiscal Reserves	Fiscal Gap in 2041-42	
			% GDP (nominal)	$ Billion
No Service Enhancement Scenario	2029-30	2041-42	4.1%	293

5.10 Before the surface of the structural deficit problem, the fiscal reserves balance is projected to rise from $755 billion (34.0% of nominal GDP) in 2014-15 to $1,398 billion (32.8% of nominal GDP) in 2028-29. Thereafter, it would be depleted in 2041-42 and resulted into debt liabilities at a level of $271.1 billion (3.8% of nominal GDP) (*Chart 5.3*).

5.11 Under the **Service Enhancement Scenarios**, the structural deficit problem would start within a decade or two, as detailed below –

Base Case	Projected start of Structural Deficit	Projected depletion of Fiscal Reserves	Fiscal Gap in 2041-42	
			% GDP (nominal)	$ Billion
Service Enhancement Scenarios *@ 1% per annum*	2024-25	2034-35	8.6%	611
@ 2% per annum	2022-23	2031-32	14.2%	1,006
@ historical trend	2021-22	2028-29	21.7%	1,542

Chart 5.3 – Projection on fiscal reserves / debt balance under Base Case



Sensitivity Analysis

5.12 The Working Group has reviewed the sensitivity analyses performed on the revenue and expenditure projections under the High Case, Low Case and Shock Case as defined in Chapter 2 –

(a) **High Case** – the faster growth in the economy would yield higher revenue and at the same time higher inflation rates would increase the expenditure in nominal terms. The faster economic growth would also drive up those categories of expenditure which are assumed to grow in line with GDP.

(b) **Low Case** – just the opposite of the High Case, under the slower economic growth environment, revenue would be less and lower inflation rates would reduce the expenditure growth in nominal terms. The slower economic growth would also reduce the growth in those categories of expenditure which are assumed to grow in line with GDP.

(c) **Shock Case** – it is assumed that a severe economic downturn would take place in 2015[1] which would adversely affect the economic growth and price factors for five years before they return to normal trend. Given its inelastic nature, government expenditure would not be able to adjust downward in tandem under the Shock Case. The expenditure projection for this case has assumed that the Government would introduce some austerity measures and the civil service pay would be frozen in 2016-17 and reduced by 3% p.a. for 2017-18 and 2018-19. It is further assumed that most of the recurrent expenditure would be frozen until the economy returns to a level before the downturn. On the other hand, as government revenue is volatile, the economic downturn would have immediate impact on the revenue projection. While counter-cyclical measures would usually be introduced in economic downturn, no such measure is assumed in the Shock Case.

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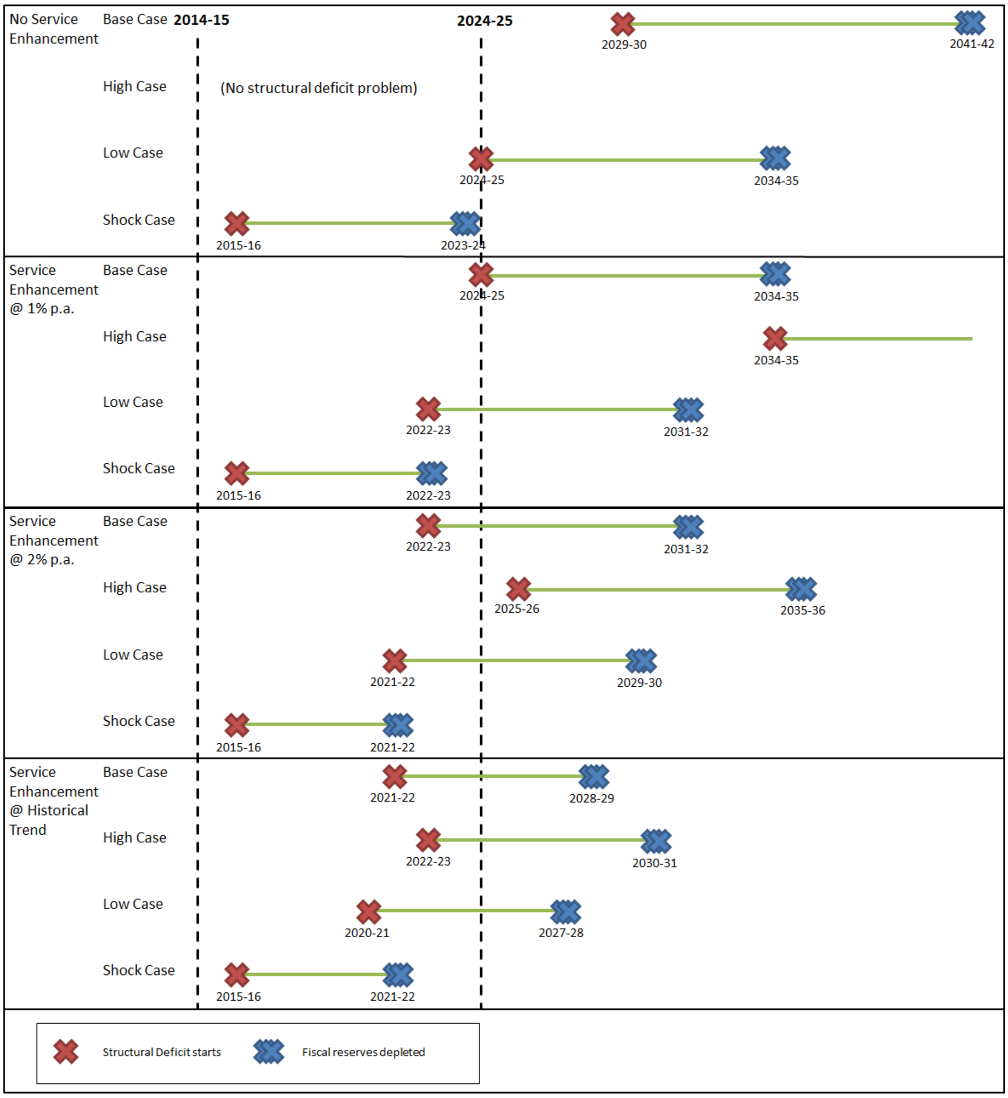
[1] The Shock Case is essentially hypothetical, being purely for the purpose of sensitivity testing in this fiscal projection exercise. It does not represent the Government's view on the economy from 2015 onwards. See Paragraph 2.16(c).

5.13 The results of the sensitivity analyses show that, except for the No Service Enhancement Scenario under the High Case, projected expenditure growth would outpace the growth in revenue, although in different magnitudes. The emergence of the structural deficit problem is a matter of time. If services in education, social welfare and health are to be enhanced as assumed under the Service Enhancement Scenarios, the problem would turn up **within a decade or two**, followed by the depletion of our reserves within another decade (*Chart 5.4*). Detailed results of the sensitivity analyses can be found at **Annex F**.

Chart 5.4 – Projected timeline for the start of structural deficit and depletion of fiscal reserves



5.14 It is worth noting that the Shock Case has demonstrated that given the inelasticity of government expenditure and the volatility of revenue, a major economic shock could immediately trigger a structural deficit.

5.15 The Working Group has made a conscious effort to avoid overstating expenditure requirements. The foregoing has **not taken into account the enormous fiscal pressure which the Housing Authority is under, and which might need to be shouldered in part by the Government.** Even under the 2013 commitment to produce an average of 20 000 public rental housing (PRH) and 5 000 Home Ownership Scheme units a year, the Housing Authority is projected to have a funding shortfall as from 2019-20 and the cumulative shortfall to 2041-42 could be **$490 billion** (assuming PRH rent could be raised 5% every two years) **or $130 billion** (assuming PRH rent could be raised 10% every two years). The figures have not reflected the costs of the additional commitments (8 000 instead of 5 000 HOS units each year) set out in the 2014 Policy Address. Although the Authority has to ensure that the revenue accruing to it from its estates shall be sufficient to meet its recurrent expenditure on the estates, the Government will have to support the public housing production programme where necessary. If the Housing Authority's shortfalls were deemed government obligations, the surface of structural deficit and the depletion of the fiscal reserves could be advanced by three years under the No Service Enhancement Scenario.

5.16 Long-term projections are not year-on-year forecasts. There are bound to be limitations. But transparency facilitates understanding. Projections under various cases and scenarios in the report can be found in the website of the Treasury Branch.

Conclusion

5.17 The current healthy fiscal situation would last much shorter than one may expect. The combined effect of a maturing economy and an ageing population imply that even under the **No Service Enhancement Scenario**, the Government would face a structural deficit problem in 15 years' time. Under the various **Service Enhancement Scenarios**, the problem would surface within a decade under the Base Case.

5.18 **The scale of the structural deficit could be serious**. Except for the No Service Enhancement Scenario under the High Case, a structural deficit is projected to surface within a decade or two under all other scenarios. The fiscal gap by 2041-42 could range from 4.1% of nominal GDP under the Base Case with No Service Enhancement Scenario to between 14.8% and 30.6% of nominal GDP under the Shock Case with Service Enhancement Scenarios. Fiscal reserves could be depleted within another decade after the onset of structural deficit. The community should be fully apprised of the projected fiscal outlook.

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

5.20 It is a requirement of Article 107 of the Basic Law for the Government to keep expenditure within the limits of revenues, avoid deficits, and keep the budget commensurate with the GDP growth. The Working Group considers that there is a need to strengthen fiscal discipline to minimise the risk of structural deficits.

5.21 To escape from the trajectory of becoming a debt-ridden economy and ensure sustainability of public finances, early actions should be taken to tackle the projected structural deficit. The Working Group has prepared recommendations on possible fiscal measures in Chapter 7.