Chapter 3 – Soldiering On

Long-term Fiscal Sustainability Appraisal 2014

3.1 Nine months have lapsed since the publication of the Working Group Report in March 2014. With the release of this supplementary report, the Working Group would like to take the opportunity to –

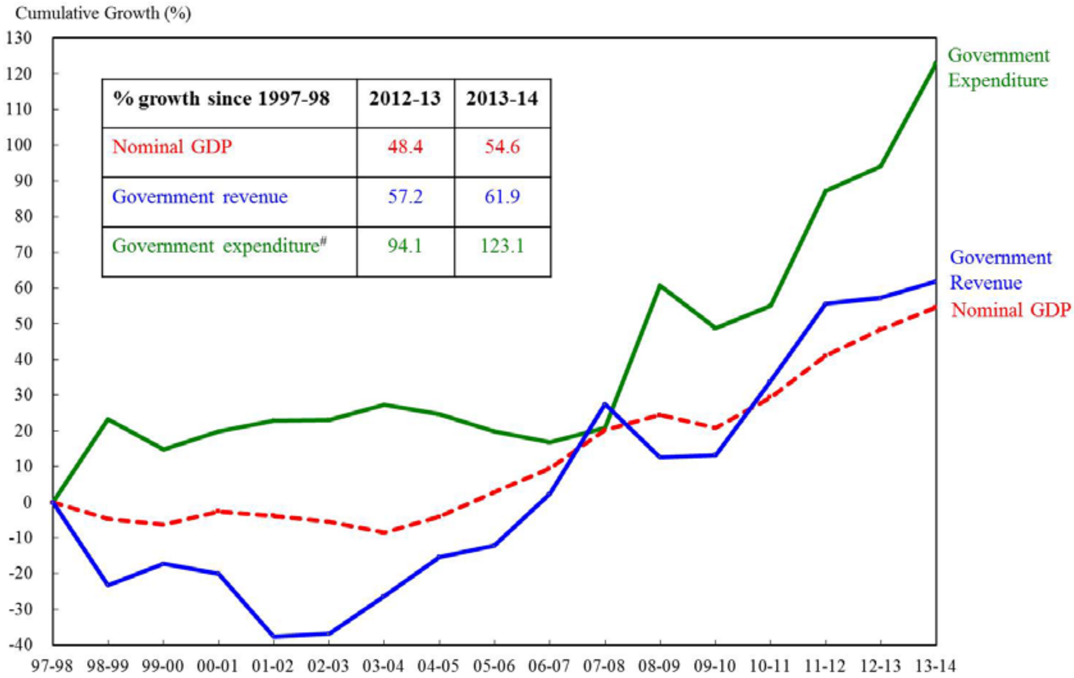
(a) rehearse the key findings of the long-term fiscal sustainability appraisal for Hong Kong, taking into account the actual (vs estimated) budgetary position for 2013-14; and

(b) take stock of what the Government has done to avert the structural deficit problem.

3.2 **The fiscal position of Hong Kong remains healthy**. 2013-14 yielded a budget surplus of $21.8 billion.

3.3 **Article 107 of the Basic Law** stipulates that Hong Kong *"shall follow the principle of keeping the expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product"*. Between 1997-98 and 2013-14, government expenditure grew by 123% on a cumulative basis, **far outpacing** the corresponding GDP growth of 55% and revenue growth of 62%.

Chart 3.1 – Growth since 1997-98



% growth since 1997-98	2012-13	2013-14
Nominal GDP	48.4	54.6
Government revenue	57.2	61.9
Government expenditure#	94.1	123.1

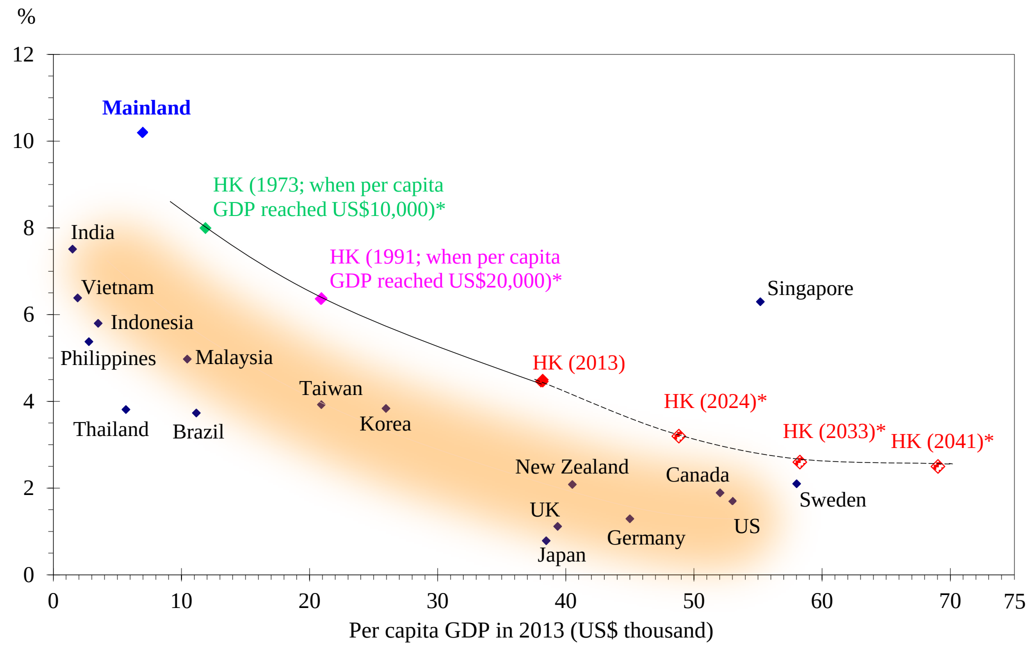
Government expenditure includes repayment of bonds and notes.

3.4 **The community in Hong Kong is ageing, at a pace relatively faster than many other economies**. The age group at or above 65 years old was 15% of the population in 2014, but would be 30% in 2041. The cost of health care and elderly-related welfare services would increase as a share of government expenditure and GDP.

3.5 Assuming that services would only be adjusted to reflect demographic and price changes but would not be enhanced from 2013-14 to 2041-42 (as in the **No Service Enhancement scenario**), the Working Group projected that government **expenditure** would grow at a trend rate of **5.3%** per annum. If services were enhanced and expenditures allowed to grow at 1%, 2% or 3% per annum, the trend rates of government expenditure growth would respectively be 6.0%, 6.7% or 7.5% per annum.

3.6 However, the growth potential of Hong Kong as a mature economy would be constrained by a declining labour force, even assuming that labour productivity would continue to stay at very competitive historical rates. The Working Group projected the long-term trend **GDP** growth at 2.8% per annum in real terms or 4.4% in nominal terms. By way of comparison, the 2004 – 2013 ten-year trend growth of mature economies like the UK, USA and Singapore were 1.1%, 1.7%, and 6.3% respectively. The long term trend growth in government revenue is projected at 4.5% (nominal) per annum.

Chart 3.2 – 10-year trend real GDP growth (2004-2013, unless otherwise stated)



* Per capita GDP figures for these data points are in 2013 constant dollar terms, i.e. they have been adjusted for change in prices over time for more meaningful comparisons. The figures beyond 2014 are projected figures derived from the macroeconomic assumptions under the Base Case and Census and Statistics Department's population projection.

3.7 Read together, the long term expenditure and revenue projections reveal that **structural deficits would surface within a decade under most of the scenarios tested**. Resolute and early action is needed to prepare Hong Kong for coping with the fiscal challenges.

3.8 The Working Group has recommended a full package of measures to step up fiscal discipline and mitigate the damages that fiscal pressures may bring to the community. These are flagged up below –

(a) containing expenditure growth,

(b) preserving, stabilising and broadening the revenue base,

(c) saving for the future,

(d) segregating and balancing the Operating and Capital Accounts,

(e) making clear what the fiscal reserves cover,

(f) stepping up the management of the Government's assets, and

(g) sustaining the financial health of the Housing Authority.

Government Response

3.9 The Working Group appreciates that the Financial Secretary has taken on board many of the recommendations. Other than considering new policies to enhance labour participation and stimulate economic growth, the Financial Secretary has **launched a series of measures to contain the growth of government expenditure**. The latter includes –

(a) containing overall government expenditure growth within the forecast nominal GDP growth rates over the medium term;

(b) launching a 0-1-1 envelope savings programme (0% in 2015-16, 1% in 2016-17 and 2% in 2017-18 on a cumulative basis) for government operating expenditure for three years;

(c) launching a re-engineering and reprioritisation programme to prompt departments to drop outdated service priorities and re-engineer work procedures to save recurrent expenditure in the coming two to three financial years. The savings will be used to provide new and more targeted services;

(d) requiring the conduct of financial impact assessment for major new policies estimated to cost over $500 million a year;

(e) identifying individual policy areas for fundamental expenditure review to achieve the aim of doing more with less by streamlining procedures or consolidating potentially redundant services;

(f) considering options for multi-year funding for suitable subvented organisations should this save administrative work;

(g) streamlining and simplifying tender requirements and reducing unnecessary assessment criteria for marking schemes to enhance procurement efficiency; and

(h) seeking ten-year projections for capital works projects in critical areas such as developing land, enhancing healthcare and elderly facilities, and improving the environment.

3.10 The Financial Secretary has also **committed to exploring ways to broaden the revenue base**. To avoid excessive reliance on direct taxation, the Government has accorded more priority to indirect taxation and other forms of non-tax revenue collection and will continue to do so. The Government will include indirect tax items, in particular those which have not been adjusted for years, as subjects for regular review.

3.11 In considering the various options on broadening tax revenue in future, the Financial Secretary will have regard to whether the option is effective in broadening the revenue base, fair and in line with the "capacity to pay" principle, and in line with Hong Kong’s simple and low tax system.

3.12 To preserve revenue, the Financial Secretary has undertaken to step up tax enforcement and would continue to review fees and charges according to the user-pay principle. As at end 2014, over 1 300 fee items have been reviewed and a further 1 000 fee items are undergoing the process; the net additional revenue arising from this latest round of comprehensive review is about $100 million per annum.

3.13 The Financial Secretary has also **tasked the Working Group to explore and propose options for a savings scheme** (**the “Future Fund”**) for Hong Kong. The Working Group’s findings and recommendations are elaborated in **Chapter 1**.

3.14 In accordance with the Long Term Housing Strategy promulgated on 16 December 2014, the public housing supply target is to deliver 290 000 units in the next ten years. To ensure that the Housing Authority has adequate funding to meet that target, the Financial Secretary **announced on 18 December 2014 the establishment of a Housing Reserve** by earmarking the investment return on the fiscal reserves for 2014 (about $27 billion) for such purpose. The Housing Reserve and its investment return will be used to support the public housing development programme and related infrastructure.

3.15 To recapitulate, the Working Group has forewarned in the March 2014 Report that even under the 2013 government commitment to produce an average of 20 000 public rental housing (PRH) and 5 000 Home Ownership Scheme units a year, the Housing Authority would be 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 latest ten-year target of 290 000 units would add to the pressure.

3.16 Given the huge financial commitment needed to support the public housing programme, advance planning is needed. The Financial Secretary intends to make provision for the Housing Reserve when the fiscal position is still steady; the Housing Reserve would be built up by instalments to reduce fiscal volatility. When the Housing Authority is ready and can reach agreement with the Government on the exact quantum and timing of financial support from the Government, formal approval will be sought from the Finance Committee of the Legislative Council for the sum to be appropriated.

Facing the Challenges Together

3.17 The long-term fiscal challenges brought by an ageing population and anticipated slower economic growth are very serious and require the concerted effort of the Government and the community to help drive changes.

3.18 In order to relay the key findings and recommendations of the Working Group's March 2014 Report to the community in a more "user-friendly" manner, four videos and an interactive game have been prepared. Readers are welcome to view the videos and try out the interactive game at the website of the Treasury Branch, Financial Services and the Treasury Bureau (http://www.fstb.gov.hk/tb/en/).

3.19 It is of the utmost importance that the Government and the community work together to maintain strict fiscal discipline as stipulated in Article 107 of the Basic Law by keeping expenditure within the limits of revenues in drawing up the budget, striving to achieve a fiscal balance, avoiding deficit and keeping the budget commensurate with the growth rate of GDP. The Working Group is confident that with resolute and timely action to address the fiscal sustainability issue, the structural deficit problem can be delayed or even averted.