Chapter 7 – Proposed Fiscal Measures

Overview

Structural deficit looming

7.1 As the Hong Kong economy matures, and as our economic growth becomes constrained by the ageing population –

(a) nominal **GDP** growth under the **Base Case** is projected to lower from 5.5% per annum in the coming years to 5% per annum in the late-2010s, 4.5% as from 2022 and further to 4% as from 2026. For ease of presentation, this implies a growth rate of **4.4% per annum** up to 2041, lower than the corresponding 5.4% per annum for the past 10 years;

(b) **government revenue** is projected to grow at **4.5% per annum** to 2041, following rather closely the expected growth pattern of the economy;

(c) however, **government expenditure** is projected to grow at **5.3%** per annum under the No Service Enhancement Scenario or between **6%** and **7.5%** per annum under the various Service Enhancement Scenarios to 2041.

Table 7.1 – Projected annualised trend growth rates of GDP, government revenue and government expenditure

	Projected Trend Growth (Base Case, No Service Enhancement Scenario)	**Trend Growth in recent years**	
	2014-15 to 2041-42	1997-98 to 2014-15	2009-10 to 2014-15
Real GDP	2.8%	3.4%	3.9%
Nominal GDP	4.4%	2.9%	6.0%
Government revenue	4.5%	2.5%	6.2%
Government expenditure	5.3%	4.7%	7.5%

7.2 Despite the healthy state of our public finances at the moment, the Base Case **No Service Enhancement Scenario** reveals that a **structural deficit** could strike in 2029-30 (within 15 years) even if services for the education, social welfare and health sectors were to be maintained at existing levels, and expenditure would grow merely with price changes and demographic changes. The problem could surface much earlier (within a decade) under the **Service Enhancement Scenarios**.

Fiscal health deteriorating

7.3 Unless the Government takes timely, resolute and effective measures to address the problem, the healthy state of our public finance would deteriorate gradually under the No Service Enhancement Scenario and more rapidly under the three Service Enhancement Scenarios, by phases –

(a) **Living with surplus** – government revenue is still projected to exceed government expenditure in the coming years and the Government would still be able to build up the fiscal reserves. The good years ahead will give the community a false sense of security.

(b) **Living on reserves** – a structural deficit could surface within a decade or two should government expenditure growth keep exceeding revenue growth. The Government would be dipping into the fiscal reserves to fund the shortfalls. Depending on the expenditure pattern, this could last for seven to 12 years.

(c) **Living on borrowing** – upon exhaustion of fiscal reserves, the Government would have no choice but to borrow to make ends meet. Debt liabilities could escalate quickly.

7.4 With our fiscal reserves still standing strong, and with Government having achieved successive years of budget surplus since 2004-05, the community may find it hard to accept the harsh reality that a structural fiscal problem could strike within a decade or two. The Working Group is conscious of the need to **avoid exaggerating the expenditure projections**. In fact, the projections are based on the current policies and service levels, including the new policies and initiative announced in the 2014 Policy Address or reflected in the 2014-15 Budget. The projections have **not** taken into account the financial implications that could arise from policy initiatives under consultation or review, including those relating to kindergarten education, health protection scheme (except for the $50 billion set aside for 2015-16), etc.

7.5 The Working Group is also conscious of the need to **avoid understating the revenue projections**. The current projections - that government revenue would move in tandem with GDP and would stay at around 20% of GDP from now to 2041-42, are **rather robust** already given the projected decline in labour force in a fast ageing economy. These projections for Hong Kong are also very consistent with the revenue trends in the seven economies reviewed; as a percentage of GDP, their revenue streams tended to fluctuate within a very narrow margin.

7.6 The Working Group holds strongly that the projections from this report should be treated as a wake-up call for the Government and the community to appreciate the scale of the structural deficit problem that could beset the Hong Kong community, given the ageing population and other known and potential financial commitments. The size of the fiscal deficit problem and the timing it sets in would depend in large part on how effective the Government is in aligning the growth in government expenditure with the growth in government revenue and the economy.

Fiscal consolidation needed

7.7 To minimise the impact of a looming structural deficit and to delay its trigger, the Government must guide the community through a tough **adjustment** process. This would require public education, buying in from the community, and ultimately determination and leadership on the part of the Government to take steps towards fiscal consolidation.

7.8 The Working Group appreciates that it is difficult for the Government to resist pressure to spend more on worthy priorities, especially during good years. But experience overseas shows also that it is far more difficult having to pick up the pieces when government debts run high, when government services have to be cut even in a recession, and when short-term fixes can no longer work to alleviate the long-term problems. The Working Group would therefore recommend that **early and pragmatic steps** be taken.

7.9 The Working Group acknowledges that no simple measure exists to solve the structural deficit problem. As it is not tasked to identify and analyse policy options that fall beyond the remit of the Treasury Branch of the Financial Services and the Treasury Bureau, the Working Group has focused mainly on fiscal measures, as elaborated in the following sections. The broad directions are –

(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.

(A) Containing expenditure growth

7.10 Since the 1970s, successive Financial Secretaries have adhered to the budgetary principle that, over time, expenditure growth should not exceed the growth of the economy. This principle has in fact formed part of Article 107 of the Basic Law, which offers the constitutional framework for the prudent management of the public finances.

7.11 The Working Group noted with concern that growth in government expenditure in recent years has outpaced that of the economy. With the impact of an ageing population setting in and government expenditure set to escalate, and with government revenue forecast to stay at around 20% of GDP, it is no longer sustainable to continue the past rates of expenditure growth.

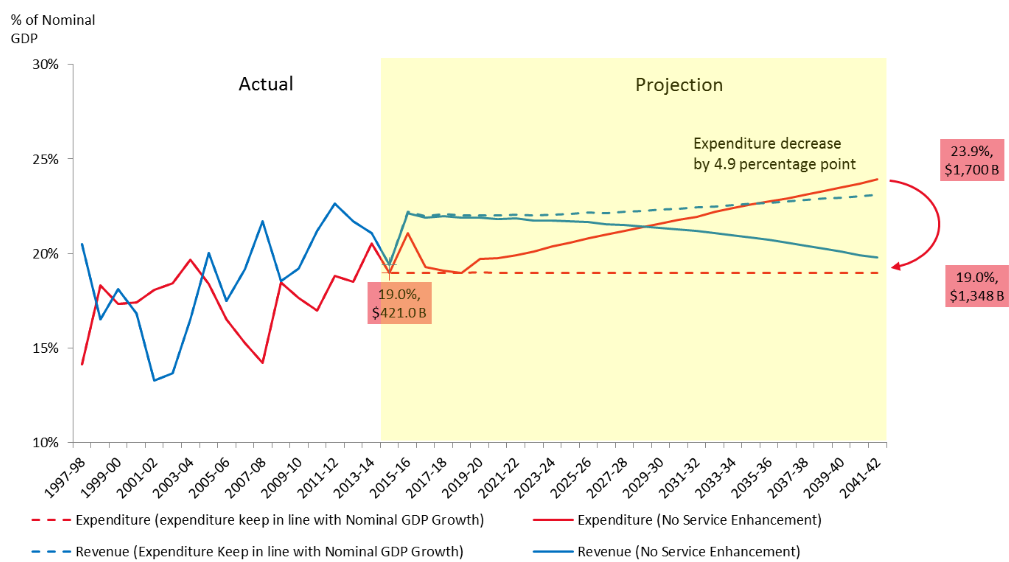
7.12 The Working Group sees a strong need for the Government to retain the expenditure rule and to enforce it with added rigour. The Working Group's specific recommendations are described in the ensuing paragraphs.

Capping overall expenditure growth

7.13 When preparing for the annual budgets, the Government should adopt the forecast nominal GDP growth rates over the medium term as planning ceilings for the growth allowed for aggregate government expenditure. Greater regard should be given to long-term affordability, and resources should be directed to areas that promote economic growth amongst other competing community needs. A vigorous and effective internal monitoring mechanism should also be in place to ensure that extraordinary growths allowed for any particular policy area group must be offset by slower growths or even cuts in other areas.

7.14 For illustration purpose, the estimated government expenditure in 2014-15 is 19% of nominal GDP. If the Government could contain expenditure growth in line with the nominal GDP growth from now to 2041-42, government expenditure would grow at an average rate of 4.4% per annum, and would stay at 19% of nominal GDP in 2041-42. There would be annual budget surpluses ranging from some 3% to 4% of nominal GDP under the Base Case. An illustration is as follows –

Chart 7.1 – Projections on revenue and expenditure



7.15 As compared with the Base Case No Service Enhancement Scenario, expenditure in 2041-42 could be reduced by 4.9 percentage points and revenue could increase by 3.3 percentage points of nominal GDP as a result of additional investment income.

7.16 Containing expenditure growth is the most direct and effective measure to help reduce the fiscal sustainability problem. Its implementation would require tough sacrifices. It is worth noting that 19% of nominal GDP is even lower than the projected share of 23.9% of nominal GDP under the No Service Enhancement Scenario. It follows that this expenditure ceiling would effectively entail negative real growth in service level through service cuts or offsetting extraordinary growth in one area by reduction in another.

Containing the size of the public sector

7.17 Successive Financial Secretaries have applied 20% of GDP as the guideline ratio or ceiling for the size of the public sector. When first quoted in the 1976-77 Budget Speech, the then Financial Secretary stated that *"when public expenditure, appropriately and consistently defined, reaches a certain proportion of total expenditure of the GDP, the growth rate of the economy as a whole is damaged for resources are being used less profitably in the public sector than they could be in the private sector."* (paragraph 31 of Concluding Speech, 1976-77 Budget).

7.18 Paragraph 33 of the same Speech stated that "*the guideline ratio for the size of the public sector is only one of the several guidelines which I bear in mind when devising budgetary strategy…none is absolute, but each is grounded in historical experience….*"

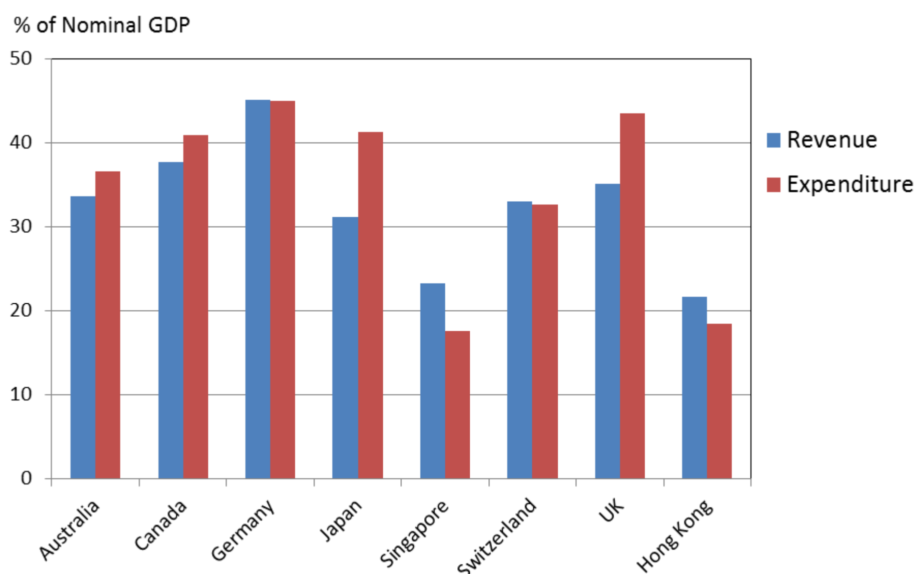
7.19 Between 1997-98 and 2012-13, annual public expenditure was on average 19.3% of the GDP, with the Government's expenditure being 17.4% of GDP, and that of the Housing Authority and the Trading Funds averaging at 1.9% of GDP. Looking forward, Government's expenditure alone is projected to grow to 23.9% of GDP by 2041-42 under the Base Case No Service Enhancement Scenario.

7.20 The Working Group has reviewed whether the 20% guideline for the public expenditure is still relevant and appropriate. On the one hand, the Government's expenditure is projected to grow well beyond 20% of GDP, and the Housing Authority has committed to an aggressive works programme. There is clear pressure for public expenditure to grow beyond 20% of GDP in the long run. On the other hand, government revenue is projected to continue yielding only at around 20% of GDP. In fact, **government revenue as a percentage of nominal GDP has seldom exceeded 20%** (only seven times in the past 40 years). Thus, the "excess" in public expenditure beyond 20% of GDP is not likely to be matched by a corresponding "excess" in revenue. Unless we

manage to boost our economic growth to increase revenue yield and substantially broaden our revenue base beyond 20% of GDP, it would not be prudent to allow public expenditure to grow well beyond its earning capacity.

7.21 The Working Group noted occasional comments that Hong Kong could be losing out to other economies because we were not spending enough on education, infrastructure, etc., and that therefore we should seek to raise our investments in various policy areas beyond the 20% of GDP limit to catch up with others. As *Chart 7.2* below illustrates, however, the expenditure profile of different economies is very much dictated by its revenue profile. With revenue roughly measuring around 20% of GDP, it would not be responsible to require the Government to spend up to say 40% of the GDP. Living within one's means is a basic fiscal discipline. It should be noted that fiscal discipline does not require stalling all new and worthy initiatives – because the economy is still projected to grow, albeit at a slower pace. But it does require greater regard to long-term affordability, and readiness to accept offsetting savings.

Chart 7.2 – Revenue and expenditure of overseas economies in percentages of nominal GDP



7.22 On balance, given the need for tightening fiscal discipline, the Working Group **recommends** that the “20% of GDP” guideline for the public expenditure be retained.

Assessing fiscal sustainability before introducing major spending initiatives

7.23 The Working Group sees a need to pay **greater regard to longer term affordability and fiscal sustainability**. As a tool to assist in decision making, the Working Group **recommends** that the Government should require all major spending initiatives (say those involving recurrent funding of $100 million or more) to go through a fiscal sustainability assessment (covering affordability, cost effectiveness and value-for-money angles). An assessment model making reference to the model established for the Working Group should be developed. The new model should ideally be able to take into account the cumulative impact of spending initiatives that straddle across different policy bureaux.

Doing more with less

7.24 When expenditure growth is constrained, the public sector would need to introduce frugality measures to try to do more with less. The Working Group **recommends** that the major spending bureaux/ departments and key subvented bodies should undertake fundamental expenditure reviews to explore ways and means for enhancing productivity.

7.25 The Working Group also **recommends** that the Government should launch service-wide economy and re-engineering and reprioritization (R&R) drives periodically in order to ensure that the public service would remain lean and efficient. Resources held back by outdated priorities should be released and work with little or no value-added should be dropped. Greater effort should be directed to streamlining work processes and compliance requirements.

Managing the capital works programme

7.26 When preparing the long-term projections for the capital works programme (covering works funded under CWRF and the Lotteries Fund), the Working Group has assumed that these expenditures would remain as a constant share of **real** GDP, at 3.4% based on the historical average over some 30 years. Since the public construction output price tends to rise more rapidly than the GDP deflator, the capital works programme is projected to grow and reach some 7.2% of the **nominal** GDP by 2041-42, compared with 3.2% in 2014-15. This projected growth trend of the capital works programme, well exceeding that of the economy over time, would not be fiscally sustainable. It would also undermine the counter-cyclical effect which capital works projects may occasionally be designed to bring.

7.27 The Working Group **recommends** that the Government should manage the capital works programme with a view to keeping the annual cash flow requirements at or around 3.2% of the nominal GDP over a period. The Working Group appreciates that the capital works programme delivers important transport, economic, health, education and social infrastructure and underpins the long term economic development for Hong Kong. As such, the Government's continuous commitment is important. There are over 700 works projects that are under way and many others have reached an advanced stage of planning. The Working Group does not recommend a stop-go approach to the planning of long term infrastructure projects. However, when considering new projects for the medium term and beyond, there will be a clear need to prioritise the use of resources under both the CWRF and the Lotteries Fund. The Government should review the phasing of projects to avoid bunching and capacity constraints driving prices.

7.28 Capital projects under the CWRF account for the lion's share of the capital works programme being tracked. These CWRF projects are mainly funded by land revenue receipts accruing to the CWRF. Since land revenue is projected to be around 3.3% of nominal GDP in the long run, managing the capital works expenditure at or around 3.2% of nominal GDP over a period is not unreasonable.

7.29 In short, the Working Group **recommends** that –

(a) Overall expenditure growth should be contained, with offsetting from programmes within and amongst different policy area groups.

(b) Having regard to the long-term revenue projections, public expenditure should be contained at around 20% of GDP.

(c) Fiscal sustainability should be assessed for major recurrent spending initiatives exceeding $100 million.

(d) Fundamental expenditure reviews should be undertaken for the key spending bureaux/departments and subvented bodies.

(e) Service-wide economy and re-engineering and repriortisation drives should be launched periodically to ensure that the public service would remain lean and efficient.

(f) The capital works programme should be managed with regard to the nominal GDP growth and the Capital Account balance.

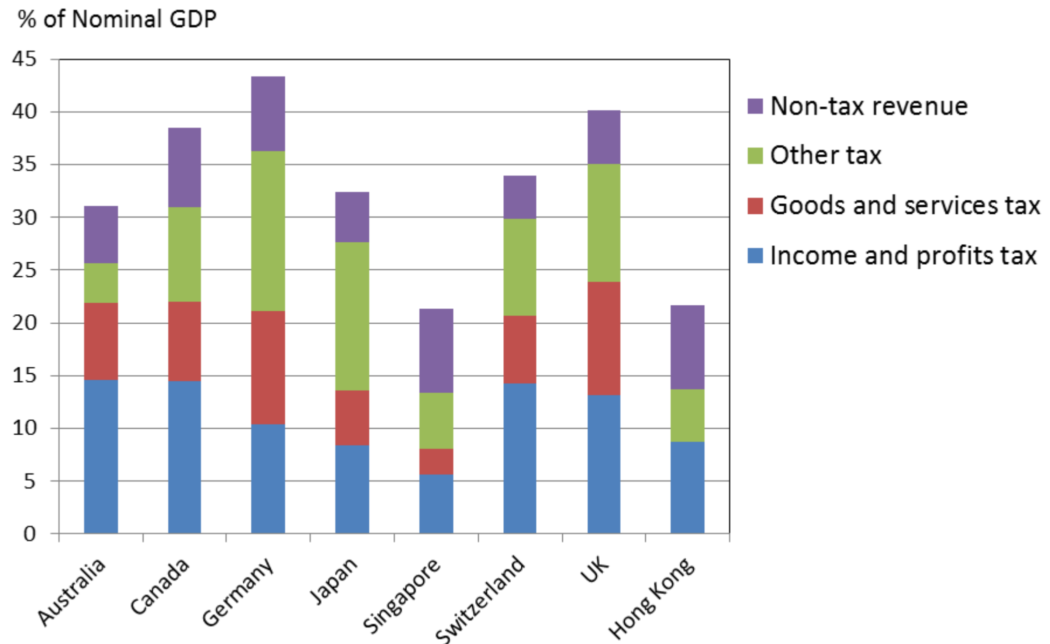
(B) Preserving, stabilising and broadening the revenue base

7.30 Government revenue has tended to grow broadly in line with economic growth. Looking ahead, government revenue is also projected to grow in line with GDP and would remain at the current level of about 20% of nominal GDP (**Base Case**).

7.31 With a structural deficit looming within a decade or two, the Working Group believes that the main fix is to contain the growth of government expenditure, more so than to rely on revenue increases beyond the levels commensurate with GDP growth. The Working Group **recommends** that the other main priority of the Government is to identify growth opportunities for the economy, and to preserve, stabilise and broaden the revenue base. The latter can be achieved through avoiding excessive reliance on direct taxation, stepping up tax enforcement, avoiding base erosion and profit shifting, and reinforcing the "cost recovery", "user pay", and "polluters pay" principles, etc. In due course, the Government should continue to enhance the tax regime to ensure that the tax structure can meet with the long-term needs of Hong Kong. New revenue sources should not be ruled out.

Avoiding excessive reliance on direct taxation

Chart 7.3 – Revenue as a percentage of GDP of selected countries



Sources: Other countries - OECD (for 2010)
Singapore - Singapore 2013 Budget
Hong Kong - Government's figures for 2012-13

7.32 As seen from *Chart 7.3*, in the absence of a goods and services tax and with over 40% of non-tax revenue coming from land premium, the revenue streams for Hong Kong are more vulnerable to economic downturns as compared with other countries. To avoid excessive reliance on direct taxation, the Government should accord more priority to indirect taxation and other non-tax forms of revenue collection. Indirect tax items which have not been adjusted for years should be reviewed. Revenue from indirect tax on consumption goods such as tobacco duty and motor vehicles first registration tax should be protected to combat tax evasion.

Stepping up tax enforcement

7.33 On the premise of maintaining the existing low and simple tax regime, the Working Group **recommends** that the Government should strive to prevent revenue losses on payable taxes. Taking profits tax which is one of our key revenue sources as an example, while the number of registered corporations has more than doubled over the past 13 years (864 000 in 2011-12 year of assessment as compared to 363 000 in 1999-2000), the proportion of taxpaying corporations has decreased from 14% in 1999-2000 to 11% in 2011-12. There has indeed been an upsurge of newly incorporated companies in recent years, in particular in the past three years which recorded double-digit growth in the number of registered corporations each year. However, many of the registered corporations do not need to pay any profits tax as they are either dormant companies, newly formed corporations with the first profits tax returns not yet issued, loss cases and cases with no assessable profits (such as investment holding companies). To ensure that taxpayers comply with the statutory obligations, the Government should continue with its robust efforts to assess and recover any underpaid tax from companies through enhanced audit and investigation strategies.

7.34 With Hong Kong's expanding tax treaty network, the Government should also make use of the existing mechanism to obtain information from other jurisdictions in facilitating tax audit and investigation. Together with risk analysis by use of information technology, resources would be more effectively deployed to deal with high-risk cases which, in general, have higher likelihood of yielding larger amounts of audit adjustments and penalties. These combined measures will serve to protect Hong Kong's revenue base and create deterrence.

Reinforcing the "cost recovery", "user pays" and "polluter pays" principles

7.35 To prevent cost recovery items from being turned into heavily subsidized items, the Working Group recommends that Government should put in greater collective effort to seek to improve the cost recovery rates for various services, even though this option alone cannot contribute much to relieve our fiscal woes. The fees and charges collected in 2012-13 is $11.6 billion, representing 2.6% of our total revenue, as compared with $11.3 billion and 4% respectively in 1997-98. The Working Group also **recommends** that the Government consider introducing new revenue items when new policies or services are implemented, e.g. waste collection fees or green tax.

7.36 For illustration purpose, the Working Group has tested the impact of improving the cost recovery rates for government services. If the Government could increase the fee levels by say 8.5% per annum (with 3.5% to cover inflation and 5% to improve the cost recovery rates) for five years, the additional annual revenue that could be generated in the fifth year and onwards would be around $5.8 billion. This analysis is for illustration purpose only and does not reflect the actual situation of the current cost recovery rates of government fees and charges; nor does it imply the Government's intention to increase the fee levels of all its fees and charges by such an extent in the coming revisions.

Reviewing our tax structure

7.37 Article 108 of the Basic Law prescribes that the HKSAR –

"shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation.

7.38 Raising the tax rates for the income and profits taxes will not be in line with the bid to maintain and enhance the competitiveness of Hong Kong. Nor will this be popular.

7.39 The Working Group **recommends** that the Government should continue to enhance the tax regime to ensure that the tax structure can meet with the long-term needs of Hong Kong and the fiscal pressures in the long run. While the long-term possibility of introducing new taxes should not be ruled out, the Working Group notes that steps to broaden the tax base are bound to be controversial, as evidenced by the lack of public support for a proposed goods and services tax in the context of the Government's public consultation on tax reform conducted in 2006.

7.40 Again, for illustration purpose, the Working Group has examined the impact of doubling the profits tax rate (from 15% to 30% for unincorporated businesses; from 16.5% to 33% for corporations) and the salaries tax rate (from 15% to 30%). Even in such an extreme scenario, the estimated additional revenue would only be some $169 billion or about 8% of the nominal GDP for 2013. Such an extreme adjustment would obviously have serious and major adverse impact on the economic development of Hong Kong. It would undermine the attractiveness of Hong Kong as a place for business. The net revenue gain through such a doubling of the standard profits and salaries tax rates would be much lower than 8% of the GDP in the long run. With a projected fiscal gap reaching 8.6 to 21.7 percentage points of nominal GDP in 2041-42 under the various Service Enhancement Scenarios (Base Case), major adjustments to the profits and salaries tax alone would not be an effective cure.

(C) Saving for the future

7.41 Much has been debated over the years as to what the optimal level of fiscal reserves should be – the equivalent of 12 or 18 months of government expenditure or what. The contention has always been one between Government spending more, taxing less or a combination of these, and Government keeping enough to meet our long-term needs, given the vulnerability of our small and open economy.

7.42 It is always hard to find the right balance that can be agreeable to all. Given the obvious fiscal pressures that the long-term projections have unveiled, the Working Group believes that the call for prudence and the need to save for the next generation is far more urgent and critical than in the past.

7.43 Research shows that some economies (like Australia) have created funds for stabilisation and savings purposes. Depending on their specific objective, these funds are named as stabilisation funds, savings funds, funds for future generations, etc. These funds are meant to be locked up until after an agreed period, or until the savings have accrued beyond planned levels. They may also have escape clauses that allow the government to draw on them in case of need like successive budget deficits. In the case of Singapore, constitutional safeguards exist such that the Government of the day cannot draw on the reserves accumulated during previous terms of Government (Past Reserves) unless with the approval of the President; only up to 50% of the net investment return, on a real basis, on past reserves could be deployed as government spending every year. The reserves are invested with the aim of generating sustainable returns over the long-term.

7.44 In view of the anticipated future spending pressure for Hong Kong, the Working Group **recommends** that the Government should start saving for the future. The objective is to set aside a portion of the fiscal reserves and annual surplus, invest these, so that the provision can be released after a designated period to help relieve

the pressure on the future generations.

7.45 Worth noting is the special nature of the Land Fund which was formed by Resolution in 1997 to receive and hold all the assets, upon the establishment of the Government of HKSAR, from the HKSAR Land Fund. The Fund does **not** have expenditure and has not been forming part of the Operating or Capital Account of the Government although its balance is treated as part of the fiscal reserves. The Fund attracts investment returns. However, the Fund has no authorised use. Should the Financial Secretary decide to draw down on the Land Fund, he would need to seek the approval of the Legislative Council, as was the case in 2003-04 and 2004-05 when $120 billion and $40 billion respectively was transferred to the General Revenue Account to meet the anticipated cash flow shortfall resulted from the repeated budget deficits since 2000-01. The balance in the Land Fund cannot be "readily deployed".

7.46 As is, the Land Fund has since 1997-98 served as a *de facto* standby facility for the Government. The Working Group **recommends** that the Financial Secretary explore the feasibility of turning the Land Fund into a "Future Fund" or savings scheme for the future generation. With a ready "endowment" of some $220 billion, the Future Fund will be able to build on its investment returns. On top of this, however, the Future Fund would need other sources of income, like a percentage share of the surpluses in either the Operating/ Capital Account levels or the Consolidated Account level. The percentage contribution can be fixed for each year for **at least ten years**. As a discipline, and to avoid the Future Fund being drawn down too readily, at the expense of the future generations, there should be a time bar before withdrawals can be contemplated. The rule may be – no withdrawal earlier than ten years from start, or no earlier than after two successive years of budget deficit.

7.47 The Working Group has deliberated on whether the Future Fund should have pre-agreed designated use – say, for social welfare, health or retirement protection, etc. Since it is hard to foresee what the spending priorities would be ten years or so down the road, the Working Group **recommends** that a pragmatic approach is to leave the use and *modus operandi* open and just focus on when the amount would be drawn.

7.48 In order that the community can focus on the size of the Future Fund and avoid confusion with the other parts of the Fiscal Reserves which have other uses, the Working Group also **recommends** that the Future Fund, notionally held against the Land Fund, with regular top-ups from its own investment returns and perhaps contributions from future surpluses, should not be accounted for as part of the fiscal reserves. It will be presented separately.

7.49 The Land Fund as it is does not belong to the Operating or Capital Account. Thus, the proposal to set up a Future Fund, to be held against the Land Fund, would not have serious impact on the Operating or Capital Account (except that investment returns on the Land Fund balances would count towards the Future Fund, not the Operating Account).

7.50 The Working Group **recommends** that the savings scheme be established as soon as practicable; however, the Financial Secretary may wish to consult relevant stakeholders on the detailed mechanics on how the Future Fund should be managed.

7.51 For illustration purpose, assuming that the Future Fund would be set up by an "endowment" of $220 billion of the Land Fund in 2014-15 and one-third of the Government's future budget surpluses and investment returns (assuming 5% annual return) of the Fund are channelled to the Fund, the balance of the Future Fund ten years later in 2023-24 would be around $510 billion, or 14.7% of nominal GDP.

(D) Segregating and balancing the Operating and Capital Accounts

7.52 One of the long-established budgetary criteria is that the Government should aim to achieve a balance in the Consolidated and Operating Accounts. As stated in Appendix to the 2014-15 Budget Speech, the Government needs, over time, to achieve an operating surplus to partially finance capital expenditure.

7.53 In the light of the anticipated structural deficit, the Working Group has reviewed whether the budget balance rule needs beefing up.

7.54 The Working Group has drawn reference from the budgetary guidelines adopted in the 1970s. The ones relating to expenditure include the following –

(a) the split between **recurrent** and **capital** expenditure should be broadly 70:30;

(b) **recurrent expenditure** should absorb no more than 80% of **recurrent revenue** – the surplus would then be a cushion to help fund capital projects; and

(c) **capital expenditure** should be met by **capital revenue** (at least 20%), supplemented by recurrent surpluses (at least 60%) and if necessary **loan financing** for "self-liquidating projects"[1].

7.55 Since the 1970s, the Government's Recurrent and Capital Accounts have become more sophisticated. The Recurrent Account has been retitled as the Operating Account in 2004-05. Quite a number of funds with designated use have been established by Resolution under the Public Finance Ordinance (Cap. 2), including the Capital Works Reserve Fund (CWRF), the Lotteries Fund, the Innovation and Technology Fund, etc.

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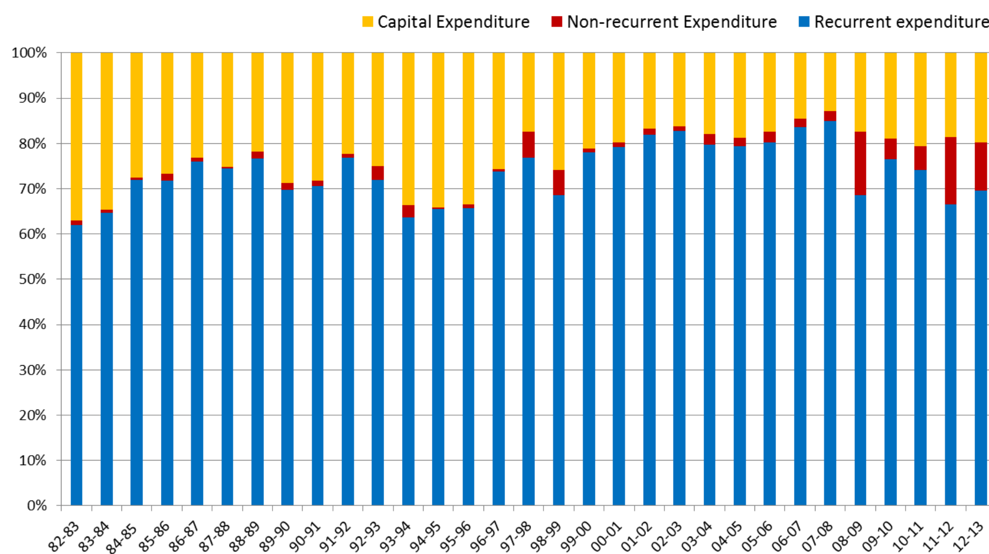
[1] Self-liquidating projects in general refer to those projects that generate adequate income to return the total amount of their costs.

Target split between operating and capital expenditure

7.56 The Working Group noted that the 70:30 split between operating and capital expenditure was broadly maintained before 1997-98. As from 1997-98, the split is generally around 80:20 as illustrated in *Chart 7.4*. Operating expenditure is further split into recurrent and non-recurrent expenditure. Non-recurrent expenditure is expenditure of one-off in nature and its requirement fluctuates yearly on a need basis. Since 1997-98, non-recurrent expenditure accounted for 0.5% to 18% of the operating expenditure.

Chart 7.4 – The split between operating (recurrent + non-recurrent) expenditure and capital expenditure



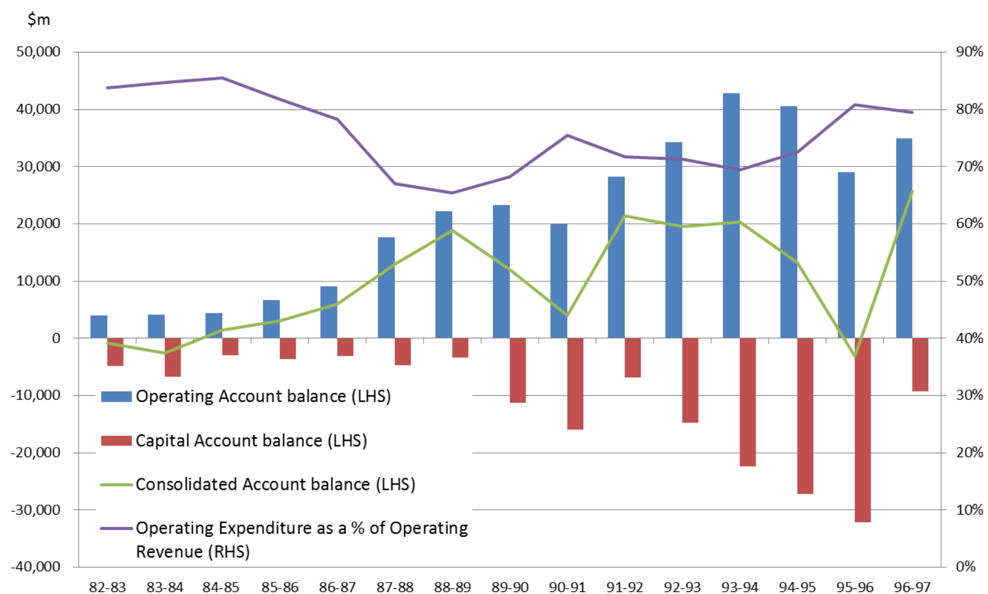
7.57 Given the changes overtime, it would not be too meaningful to impose a rigid guideline on what the split between operating and capital expenditure should be. As a principle, however, the Working Group **recommends** bringing home the simple message that recurrent expenditure tends to be a lot more inelastic than non-recurrent or capital expenditure; as such, the Government should exercise far greater caution before committing to new initiatives with recurrent (as against one-off) cost implications.

Operating expenditure as a percentage of operating revenue

7.58 Living within one's means is a fundamental fiscal discipline. It is no surprise therefore that the Government has, for years, tried to contain its operating expenditure within 80% of its operating revenue, leaving a 20% buffer to fund one-off requirements.

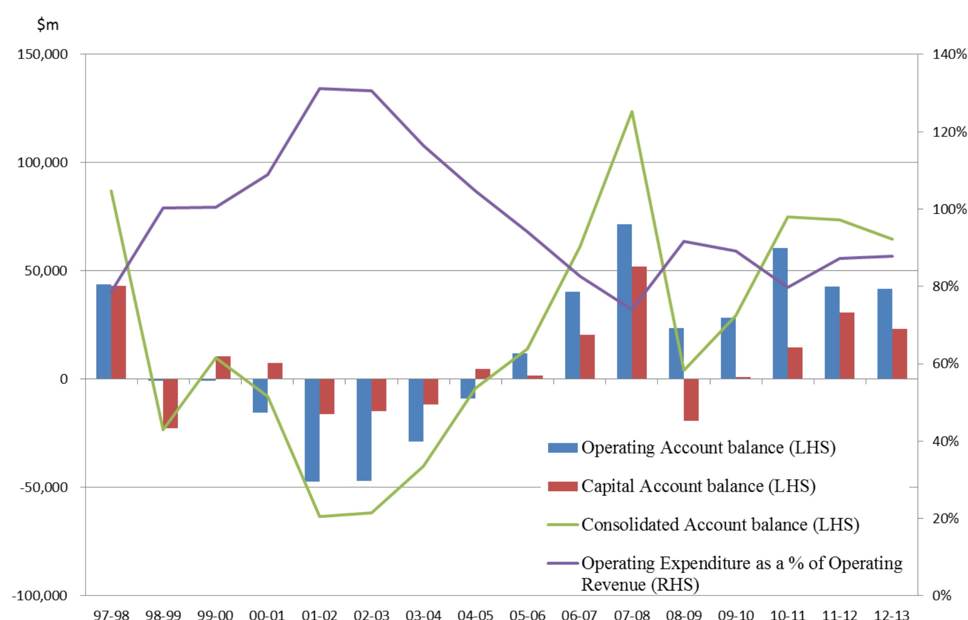
7.59 **For the 15 years prior to 1997-98**, the Government's Operating Account had consistently been running at surpluses, as illustrated in *Chart 7.5* below; **operating expenditure was on average 76% of operating revenue**. During the same period, the Government's Capital Account had consistently been running at deficits, reflecting in part the funding pressure attributed to the airport core programme, and in part the pre-1997 arrangement whereby 50% of the land sale proceeds were set aside for the HKSARG Land Fund rather than being credited to the CWRF within the Government's Capital Account. The surpluses from the Operating Account were of great help to defray the shortfalls in the Capital Account.

Chart 7.5 – Operating Account and Capital Account from 1982-83 to 1996-97



7.60 **For the 16 years between 1997-98 and 2012-13**, the role of the Operating Account to help cover shortfalls in the Capital Account has diminished, as illustrated in *Chart 7.6* below. **Operating expenditure was on average 97% of operating revenue**; as such, much less is left as buffer to help meet occasional shortfalls in the Capital Account. On the other hand, windfall surpluses in the Capital Account have tended to give rise to pressure to increase expenditure, including expenditure of a recurrent nature. This may not be financially sustainable. It should be noted that as from July 1997, land sale proceeds have been credited to the CWRF. However, land revenue (capital in nature) is highly sensitive to the performance of the economy and to changes in government policy; as such, the performance of the Capital Account is very volatile. During the economic downturn between 2001-02 and 2003-04, both the Operating and Capital accounts went into deficits; but since the Operating Account could not offer any buffer to help meet shortfalls in the Capital Account, the Government had to draw down on its fiscal reserves during the period.

Chart 7.6 – Operating Account and Capital Account from 1997-98 to 2012-13



7.61 Between 2005-06 and 2012-13, the Government's operating expenditure was on average 86% of operating revenue, leaving about 14% on average to serve as buffer for the Capital Account and other contingencies.

7.62 The Working Group has examined the propriety of reinstating a guideline to contain operating expenditure as a percentage of operating revenue. Since many mega works projects under the Ten Major Infrastructure Works Programme are still under way and since investments in economic and social infrastructure like hospitals, elderly facilities and schools, etc, would increase, the capital works programme will continue to expand and the Capital Account is projected to experience successive years of deficit in the medium term.

7.63 Looking ahead, the Working Group considers it prudent to reinstate a budgetary target for containing operating expenditure within 90% of operating revenue and would so **recommend**. The 10% buffer, if exists, may either be transferred to meet potential shortfalls in the Capital Account or be retained as reserve.

Capital expenditure and loan financing

7.64 The former guideline on capital expenditure stipulated that at least 20% of capital expenditure should be met by capital revenue and another 60% at least by recurrent surpluses. In case a shortfall remains, the 1976-77 Budget Speech stated –

"To the extent that there is an uncovered deficit on capital account, after allowing for capital revenue and the surplus available on recurrent account, the use of loan finance is legitimate, provided debt servicing charges – interest and amortization – do not, at any time, exceed interest earned on our fiscal reserves."(Footnote to paragraph 6 of the Speech)

7.65 As shown in *Chart 7.6* above, the Capital Account has been running surpluses in recent years. This means that capital revenue has been more than enough to cover for capital expenditure and it was not necessary to seek transfers from the Operating Account or to consider loan financing. That said, pressure for capital expenditure is building up. The Medium Range Forecast also forecast a deficit in the Capital Account from 2014-15 to 2018-19. It would be prudent to consider whether to allow loan financing to meet shortfalls in the Capital Account and if so, whether a limit or pre-conditions should be imposed.

7.66 With fiscal reserves running close to $750 billion, it would not seem necessary or prudent to seek to borrow. With economies rushing to impose "debt brakes" to mend their rather sorry state of public finance, it also seems counter-intuitive for Hong Kong to head down the slippery slope of "debt financing".

7.67 The Working Group would not recommend loan financing as a means to meet requirements in the Operating Account. However, if a project-specific or short-term need arises in the Capital Account (as against the Operating Account), the Working Group **recommends** that loan financing be explored. But it should only be considered where the cost of such borrowing is lower than the expected earnings arising from the fiscal reserves otherwise drawn. In addition to the financial gain from the interest differential, loan financing could allow the Government more flexibility in the deployment of resources. That said, learning from "debt brakes" overseas, the debt level for the Government to finance the Capital Account should not exceed say 5% of nominal GDP which is sufficient to cover some 19 months of capital works expenditure; for 2014-15, the estimated cash flow requirements on capital works stands at 3.2% of GDP. The proposed 5% of nominal GDP cap on debt level only applies to project-based or short-term loan financing for the Capital Account. The Government may issue bonds which exceed the suggested level for other policy considerations, such as enhancing the debt market in Hong Kong.

7.68 As a fiscal discipline, the Working Group **recommends** that the Government should segregate and seek to balance the Operating and Capital Accounts separately. The fiscal reserves usually shown at the Consolidated Account level would be attributed to either the Operating or Capital Account. And while transfers from the Operating Account to the Capital Account would be allowed, transfers in the opposite direction should not, save for exceptional circumstances. The latter restriction is needed because it is not financially sustainable to use one-off capital gains to fund recurrent initiatives. The two accounts would still be consolidated and the flexibility for them to cover each other if really needed would still be there.

7.69 An illustration of the presentation of the Operating and Capital Accounts, showing their respective surplus/deficit for the year as well as cumulative balances, is shown at **Annex H**.

7.70 The effects of loan financing for the Capital Account have also been tested. As shown in the Medium Range Forecast under Appendix A of the 2014-15 Budget Speech, the Capital Account would be in deficit from 2015-16 to 2018-19 ranging from $28 billion to $38 billion per year. For illustration purpose, if the Government were to issue $30 billion bonds each year starting from 2015-16 to finance the capital account shortfall, there could be financial gain of some $3 billion up to 2018-19 per one percentage point interest rate differential between the projected investment return of the fiscal reserves and the borrowing costs.

Recommended Guidelines

7.71 In short, the Working Group recommends that the following guidelines be imposed –

(a) The Government should aim to achieve a balance in the **Consolidated Account**. If a surplus can be achieved, the margin can be saved up to cope with cyclical downturns and longer term needs.

(b) The **split between operating (including recurrent and non-recurrent) and capital expenditure** should be targeted at 70-80:20-30. Recurrent expenditure tends to be inelastic and would be more difficult to trim in economic downturns. Thus, the financial implications of new policies with recurrent cost obligations should be carefully assessed.

(c) **Operating expenditure should not exceed 90% of operating revenue**. Surpluses from the Operating Account may help meet shortfalls in the Capital Account or may be retained as reserve.

(d) **The Capital Account should be segregated from the Operating Account and should strive to achieve a balance**. This would mean that capital expenditure, primarily expenditure on capital works, should stay within the limits of the capital revenue, primarily revenue from land disposals or lease modifications, etc, if not on a yearly basis, at least over the Medium Range Forecast period (i.e. a five-year period). Surpluses from the Capital Account, typically one-off in nature, should **not** be used to fund recurrent initiatives under the Operating Account. Shortfalls in the Capital Account should be met by surpluses from the Operating Account, fiscal reserves or through financing means.

(e) **Loan financing** may be considered for meeting project-based or short-term shortfalls in the Capital Account (as against the Operating Account). Loan financing should only be considered on the condition that the cost of borrowing is not higher than the expected earnings on the fiscal reserves otherwise drawn down, and that the debt level of the Government to finance the Capital Account does not exceed say 5% of nominal GDP. The proposed cap applies to project-based or short-term loan financing for the Capital Account. The Government may issue bonds which exceed the suggested level for other policy considerations, such as enhancing the debt market in Hong Kong. The Government may have other options like identifying assets for securitisation or asset disposal to raise one-off funding for one-off initiatives.

(E) Making clear what fiscal reserves cover

7.72 Fiscal reserves represent the cash balance for the Government. The reserves is estimated to be $745.9 billion at 31 March 2014, broken down as follows –

	$m
General Revenue Account	394,241
Funds with designated uses	131,957
Capital Works Reserve Fund	78,679
Capital Investment Fund	1,992
Civil Service Pension Reserve Fund	27,029
Disaster Relief Fund	29
Innovation and Technology Fund	1,801
Loan Fund	1,357
Lotteries Fund	21,070
Land Fund	219,730
Total	745,928

7.73 Of the $745.9 billion estimated fiscal reserves as at end March 2014, only the portion held in the General Revenue Account (about $394 billion) is for meeting the day-to-day cash flow requirements of the Government; the balance held in the Land Fund (about $220 billion) has **no authorised use**; and the balances held in various Funds set up by Resolutions of the Legislative Council (about $132 billion) **have their respective designated use**. For instance, the fund balance in the CWRF is designated for capital works, major systems and equipment; that in the Innovation and Technology Fund is committed to projects to promote innovation and technology; and that in the Loan Fund is for approved loans, etc.

7.74 For a more detailed explanation of the nature of fiscal reserves, the Working Group **recommends** making clear that –

(a) only the part of the reserves held in the General Revenue Account (about $394 billion) is for meeting the day-to-day cash flow requirements of policy bureaux and government departments in the delivery of public services;

(b) the balance held in the Land Fund (about $220 billion) has no authorised use. Approval to draw down on Land Fund has to be sought from the Legislative Council. If a savings scheme is to be introduced, the balance in the Land Fund can be deemed an initial endowment. Such a proposed Future Fund should be segregated from the fiscal reserves; and

(c) the balances held in seven Funds (other than the Land Fund) (about $132 billion) have their respective designated use in accordance with the Resolutions for setting up the Funds.

7.75 With a better understanding of the fiscal reserves, our community should have a more objective and clearer idea of our fiscal position when considering new policy initiatives.

(F) Stepping up the management of the Government's assets

7.76 The Government's asset portfolio includes investments in government business enterprises such as MTR Corporation Limited, Hong Kong Airport Authority, Hongkong International Theme Parks Limited, etc. and fixed assets such as toll tunnels and government buildings.

7.77 The main purpose of past investment made by the Government should aim to provide a worthwhile public service or to meet an important policy objective and at the same time be capable of generating a reasonable rate of return to the Government. Currently, nearly all the Government invested companies, corporations and public bodies are primarily serving a public purpose and operating under heavy policy requirements.

7.78 In anticipation of the hefty requirements in healthcare spending, capital works, pension liabilities etc., the Working Group **recommends** that the Government should manage its asset portfolio more proactively, and using the financial return to help reduce the fiscal pressures in the coming decades.

Disposal or securitisation of assets

7.79 In normal circumstances, the Government has to maintain its level of ownership in companies, corporations and public bodies either for policy or other reasons, and will not realize the value of the investment through asset sale or divestment in the market. Nonetheless, in face of fiscal pressures in the long run, sale or divestment of government assets including equity investments could be considered if one-off capital revenue is required to help reduce budgetary deficit. Another means that could be considered for easing fiscal pressure is securitisation of government assets. An example is the issuance of $6 billion's worth of Toll Revenue Bonds by the Government in 2004 which securitised the future revenue to be generated from government toll tunnels and bridges.

7.80 The extent that fiscal pressure may be eased through asset disposal or securitsation is subject to factors such as the market conditions and the quantum of the asset disposal, etc. In the selection of assets for sale, divestment or securitisation, the Government has to take into account the following considerations –

(a) whether the disposal or securitisation will result in the Government not being able to deliver the public purpose and mission. Possible examples include essential strategic infrastructure which the Government needs to maintain effective policy control on operation and development;

(b) whether the asset is generating a recurrent revenue, say in the form of dividend, to the Government. The Government should ensure that the upfront capital revenue to be received from the disposal should truly reflect the underlying asset value taking into account the recurrent revenue to be forgone;

(c) for the asset disposal option, whether Government ownership of the asset is essential and whether it is suitable for the assets to be operated by the market. Preference should be given to those assets which will bring higher efficiency and generate a higher return if owned by the private vs public sector; and

(d) impact on the community and the market as well as public reaction and acceptance.

7.81 In view of the long-term fiscal situation, the Working Group **recommends** that the Government keep in view the need for disposal or securitisation of government assets from time to time, bearing in mind the above factors. If need be, the Government should engage consultants to advise on the strategy for the holding or disposal of assets. The Working Group also **recommends** that the Government should ensure that the government business enterprises are managed and operated efficiently and cost-effectively.

7.82 For illustration purpose, the Working Group notes that under the Base Case No Service Enhancement Scenario, structural deficits would surface in 2029-30 and the total deficits for the initial two years would be around $30 billion. If the Government were to seek to cover these shortfalls by disposing its assets, some $30 billion asset portfolio would need to be identified for the purpose.

7.83 It should also be stressed that the one-off revenue from asset disposal could not resolve a structural deficit problem. It can only serve as one of the alternatives to tide over short-term financial difficulties.

(G) Sustaining the financial health of the Housing Authority

7.84 The Housing Authority (HA) has been operating with consolidated surplus which stood at $5.8 billion for the year 2012-13. With operating revenue from rental income from public rental housing units and commercial properties, proceeds from sales of Home Ownership Scheme (HOS) flats and alienation premium, and annual return from its investment portfolio, the HA maintained a cash and investment balance of $69.2 billion as at end March 2013. However, it will need substantial resources in the coming 10 to 30 years to fulfill its flats production target. According to its projection with assumption of a 5% biennial Public Rental Housing rent increase, the HA would have projected funding shortfall by 2019-20 and would run into operating deficit by 2023-24. A total funding shortfall of up to $490 billion could surface within the projection period. This has yet to take into account the new commitment on the production of 3,000 extra HOS units every year, offered in the 2014 Policy Address. The Working Group **recommends** that the Government should negotiate with the Housing Authority with a view to reducing the budgetary pressure on government finances in the long run.

7.85 The HA's original capital came from the Government. The HA has to comply with the statutory requirement under Section 4(4) of the Housing Ordinance (Cap.283) that " *[t]he policy of the Authority shall be directed to ensuring that the revenue accruing to it from its estates shall be sufficient to meet its recurrent expenditure on its estates.*" Following the enactment of the Housing (Amendment) Ordinance 1988, the Financial Arrangements between the Government and the HA came into effect on 1 April 1988. A Supplemental Agreement to the 1988 Financial Arrangements was effective from 1 October 1994. According to the Recitals of the Supplemental Agreement, "*[s]ubject to need and affordability remaining the guiding principles in the provision of, and charging for, public housing, Government will continue to support the public housing*

programme with finance to the Authority where necessary and to subsidize public housing with the provision of land on concessionary terms".

7.86 In accordance with the Financial Arrangements, formed land is provided by the Government and in return, the HA pays back in the following manner –

(a) for public rental housing, no payment on land cost is required;

(b) for commercial and non-domestic facilities, land cost is also not required but the HA pays 50% of the overall surplus from the operation of commercial and non-domestic facilities to the Government; and

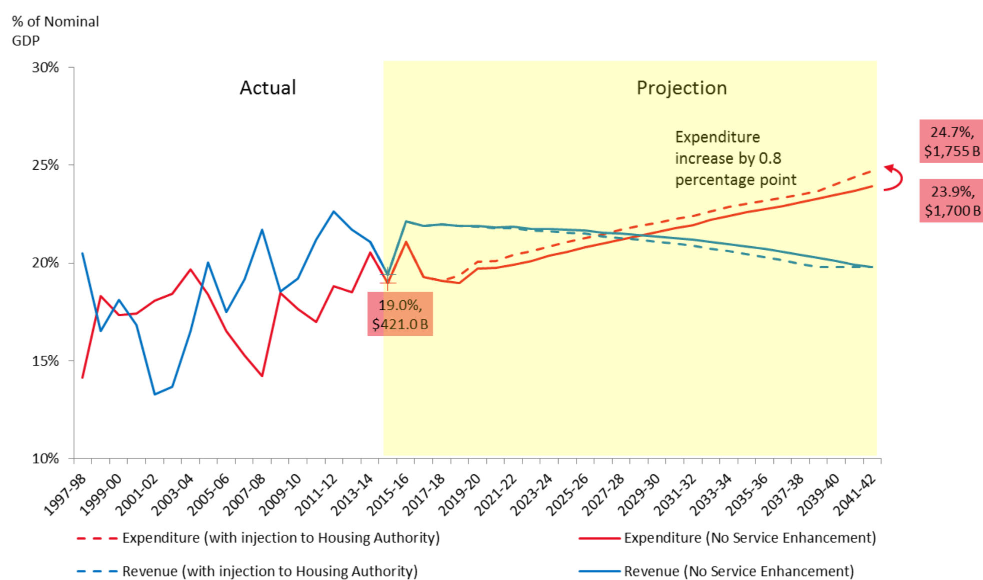
(c) for HOS, the HA pays 35% of the development cost of HOS flats sold as land costs to the Government.

7.87 As the Government would be under tremendous fiscal pressure within a decade or two, the Working Group believes that the Government should review with the HA its business model so as to meet its statutory requirement to make ends meet on a recurrent basis. It would also be prudent for the HA to consider funding options other than direct government injection. These may include reviewing the mix of public rental housing units and HOS units, HA loan financing, securitisation of HA assets and revenue enhancements across-the-board. The Working Group appreciates that these are not easy options.

7.88 The projections presented in Chapter 5 have not included the possible funding support required for the Housing Authority.

7.89 For illustration purpose, if the Housing Authority's funding shortfalls of $490 billion, as projected under the assumption of a 5% biennial Public Rental Housing rent increase, were deemed government obligations, then government expenditure by 2041-42 could increase by 0.8 percentage point, from 23.9% under the Base Case No Service Enhancement Scenario to 24.7% of nominal GDP (*Chart 7.7*). The surface of structural deficit and the depletion of the fiscal reserves could be both advanced by three years.

Chart 7.7 – Projection on revenue and expenditure



Other observations

7.90 **Exchange Fund.** As at end-March 2013, the gross assets of the Exchange Fund stood at $2,886.1 billion and the gross liabilities $2,258 billion, leaving $628.1 billion as net assets (roughly 30% of GDP). The gross assets include $1,342.9 billion assets in US dollar for backing the Monetary Base, $745.9 billion placements by the Government's fiscal reserves and $221.4 billion placements by banks and other bodies. These assets are not to be confused or double-counted with the part of the fiscal reserves which the Government has deposited with the Exchange Fund in exchange for investment returns.

7.91 With structural deficits looming, there is pressure for the Government to consider drawing on part of the **net assets** of the Exchange Fund, or at least the **investment returns** from these net assets, to fund government needs. Given the volatility of the economy and the statutory role of the Exchange Fund, it would not seem prudent for the Financial Secretary to seek to draw down on the Exchange Fund at this stage to help overcome a budgetary problem of a structural nature. As with the fiscal reserves, the net assets of the Exchange Fund are one-off in nature; once drawn, the principal left to generate future investment returns would be diminished. Compared with the scale of the structural deficit problem, which could reach as much as 22% of nominal GDP under the Service Enhancement at Historical Trend Scenario in 2041-42, the net assets of the Exchange Fund (currently standing at about 30% of nominal GDP) would pale into insignificance. As a small and open economy with no natural resource, the net assets of the Exchange Fund are the key defence for Hong Kong in times of crisis. On balance, the Working Group considers it more prudent to keep the Exchange Fund intact and segregated from the fiscal reserves of the Government. Regular draw downs from the net asset of the Exchange Fund or from its investment returns would not be a prudent or sustainable solution to the structural deficit problem.

7.92 **Public Private Partnership.** The Working Group appreciates that the scale of the structural deficit problem is enormous and the problem is too big for the Government alone to resolve. In considering options ahead, the Working Group sees a need for the Government to consider options for partnerships with the private sector, as in the case of public private partnership in capital projects and healthcare reform.

7.93 **Staggering revenue from land sales.** The Working Group has also considered options to smooth out or stabilise the **revenue stream from land sales**, like allowing land premium and other lease modification receipts to be spread out over a period. Whilst this could stabilise revenue streams over a specified period, there is no reason why Government should forego and defer receipt of its capital revenues and lose out on investment returns.

7.94 **Establishing Civil Service Pension Stabilisation Fund**. The Working Group has also considered the setting up of a **Civil Service Pension Stabilisation Fund** to smooth out the expenditure hike on pension liabilities, and to relieve the future taxpaying generation from having to bear the full brunt of these statutory commitments. If the idea of a Future Fund can be agreed, the need to establish a savings scheme dedicated to pension commitments will not be necessary.

Conclusion

7.95 In summary, the Working Group recommends –

(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 fiscal reserves cover;

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

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

7.96 As Hong Kong gears up for tougher times ahead, the Government and the community must pay heed to the pressures on fiscal sustainability and must act in a responsible manner. The Working Group sees a need for fiscal discipline to be tightened. It does **not** mean stalling all new and worthy initiatives – because the economy is still projected to grow, albeit at a slower pace. But it does require greater regard to long-term affordability, and readiness to accept offsetting savings. It requires collective effort to preserve, stabilise and where possible broaden the revenue base, and to safeguard the cost-recovery principle. It also requires advance planning, so that the Government can start saving for the future. Community expectations will need to be managed.

7.97 The Working Group would not want to paint an overly gloomy fiscal outlook for Hong Kong. But there can be no denial that Hong Kong can ill afford to continue increasing spending beyond the pace of economic growth and revenue. We have to act and behave as a mature economy. The Government and the community would need to acknowledge the problem ahead and adjust. If the Government takes serious and early action to realign the growth of expenditure with that of government revenue and of the economy, the Working Group is reasonably optimistic that the structural gap in public finances can be narrowed and the onset of a structural deficit deferred. Fiscal consolidation would go a long way to preserving the longer term stability, competitiveness and creditworthiness of Hong Kong as an international financial centre.